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CHARTERED FINANCIAL ANALYST

May 2002

The New Age Finance Magazine

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Commoditization



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Editor EN Murthy

FOCUS

Enter Commoditization

The annals of business history are replete with examples of new industries that succumbed to the natural laws of business as it evolves. The recent burst of the tech bubble demolished the notion that the tech industry had drastically altered the foundations of economy and therefore the new economy would remain immune to the business cycle forever.

In the formative stages of their evolution, industries deliver disproportionately high returns relative to others. As the players stampede, intensive price wars tend to follow. And when the industry matures it becomes increasingly difficult to be different. The products transform themselves into commodities. This process known as commoditization was evident time and again in many industries that arose and stabilized. Industries such as automobiles, electronics, telecom and PCs have gone through the evolutionary process.

It is increasingly debated as to whether the IT industry, the harbinger of the tech era is also witnessing the commoditization phase. If so, what are the implications for the incumbents and what does it portend for the future. The cover story 'IT Industry: Towards Commoditization' dwells on these crucial issues.

In the post-Enron scenario, businesses are performing forensic analyses of the excesses of the recent past. Attempts are also being made to understand how business sans ethics jeopardized the businesses. The article 'Management Consultancy: Time for few new ideas' examines the role of consulting in business failures. Corporates spend a fortune on these consulting services and their failures make the cynicism expressed in Dilbert cartoons look real. The prescriptions of the consulting community over the years too lend credence to the story. Only yesterday were the corporates advised to concentrate on their core competence. Many companies took this seriously and got rid of those businesses that they deemed non-core. The present prescription is to de-risk the business, which inter alia suggests companies to diversify to combat the risk of concentration. It seems the circle is complete.

Another article on corporate strategy, 'Big Businesses: Survival Conundrum' analyzes why big companies failed to sustain. Size is a double-edged sword that companies shall use with cautious diligence.

Against the backdrop of attempts to embrace the floating stock-based construction of stock market indices in India, the article 'Indian Stock Market Indices: To float or not to float?' analyzes the possible implications for the Indian stock markets as well as the corporates.

During the dotcom boom of the late 1990s, companies put greater emphasis on intangible assets. It was an era where physical assets were thought to have very little significance. This belief gained widespread acceptance as the new economy torchbearers like Cisco and Enron turned out stupendous performances. But with the euphoria over dotcom slowly dying down, companies are realizing the importance of 'physical' assets. The article 'Tangible Assets: Inherent virtues' emphasizes the point lucidly.

Indian Railways crosses one more milestone as it completes its 150th anniversary this year. However, that is hardly a reason to celebrate. The organization which forms a common link between India's diverse cultures and religions is today in dire financial straits.

Ch Rajeshwer

LETTERS TO THE EDITOR**Congratulations**

Kudos for the Banking Survey which was very interesting (*Analyst*, April 2002). The survey reveals the present developments in the sector. To compete with the new private sector banks, the PSBs must upgrade themselves and come out of the shadow of Government protection. Can I expect more such surveys in the future?

Prashant Kumar
New Delhi

Good Effort

I am an avid reader of finance and business magazines. I have always felt that the *Analyst* stands apart from the crowd and the April issue of the magazine has reinforced my belief. I found the banking survey very interesting and insightful. Specially the contributions from various industry players added a lot of color to the survey. Their first hand account of the industry was very informative. My thanks to the *Analyst* team for putting in such an effort and I hope that they will keep up the tempo

Malathi Srinivasan
Bangalore

Rating Issues

The article on the rating agencies and their effectiveness in gauging corporate efficiency was very informative. Credit ratings given by these agencies is one of the major factors in making the investment decision. This a failure on their part to accurately assess the prospects of a company could have long-term repercussions to a large number of investors.

Kiranmayee Chowdhary
Kolkata

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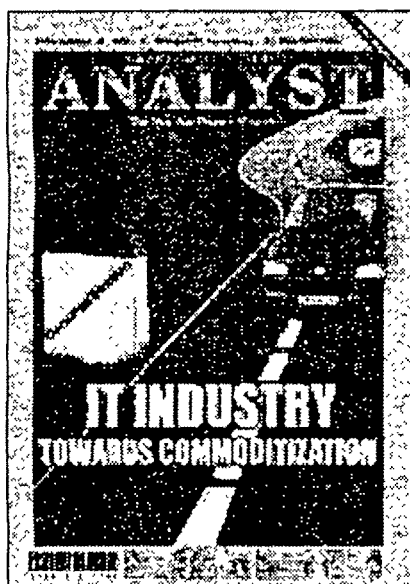
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COVER STORY



Cover design by K. Aravind

IT Industry: Towards Commoditization ... 15

Price considerations have played a major role in eroding product differentiation in the IT industry. In the West, it is quality and the features of the product that drive the purchasing decision. However, in the case of developing countries like India, price considerations have always played a crucial role in influencing consumers' decisions, *ceteris paribus*. With new entrants in the marketplace, bringing in products with similar features yet with limited price differences, competition has intensified. With increased price wars and continuous technological progress, the industry is moving towards commoditization. Commoditization, today is akin to a strong tidal wave sweeping all the segments of the IT sector. Some sectors like hardware, which were relatively weak, were washed off earlier. And other foundations like the software sector are witnessing the blow now.

SPOTLIGHT

Socially Responsible Investing

A conscience call 28
Most investors have a concern for social and environmental causes; few of them try to work towards them. Socially responsible investors are those few who invest for a cause and try to make the corporate world more responsible to the society at large. And the good news is that their numbers are growing.

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Management Consultancy

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The history of consultancy business is replete with examples of failures outscoring winners. AT&T's continuing troubles and more recently the disgraceful collapse of Enron, all tell a sorry tale about the profession. Will the idea machines generate a few fresh, and winning ideas?

Big Businesses

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While experts are still grappling with reasons for Enron's collapse, the

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premature deaths of several giant-sized organizations raise serious concerns about size.

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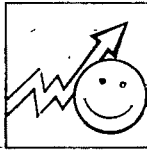
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ROUNDUP

National

Signs of revival

According to a survey done by the CII-Ascon, there are clear signals of revival in the domestic economy. Over 50 percent of manufacturing sectors exhibited a moderate growth during April 2001-March 2002 compared to the previous fiscal and may pick up during April-June 2002, if the Government takes necessary steps to hasten reforms. However, the survey did not reveal sectors, which are taking the lead as the actual figures for April 2001-March 2002 are still in the process of compilation.



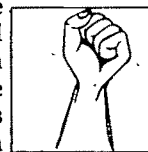
The study covered 116 manufacturing and 12 service sectors. It says the policies needed further streamlining for improving growth in the industry. The proposed spending on infrastructure and road development projects would help kick-start growth in related manufacturing segment, it added. The survey further revealed that 65 out of 116 sectors—more than 56 percent in the manufacturing—have exhibited a moderate growth of up to 10 percent during April 2001-March 2002 compared to the same period previous year. Fifteen sectors have shown higher growth rates from 10 to 20 percent and six sectors have shown excellent growth of over 20 percent. Around 30 sectors have shown negative growth.

The survey painted an excellent growth for the cellular service sector which grew by 80 percent, housing finance (33 percent) and software services (30 percent), but services in export cargo and leasing and hire purchase declined.

However, it painted a grim picture of exports. Only five of the 48 export sectors had shown excellent growth as against nine in the previous year while 34 sectors had moderate to negative growth. There was an increase in auto tyre exports due to excellent growth in the passenger car segment. The survey cited competition from China, free import under Indo-Nepal Treaty, duplication of brands, manufacture and sale of spurious products at cheaper prices and harmonization of specification standards for the grim growth.

Buoyant economic growth

According to IMF, the economic growth should remain buoyant in India this year and next, as the global economy is recovering from a downturn. It reported in its semi-annual *World Economic Outlook* that India's economy should grow 5.5 percent this year, and 5.8 percent in 2003. India's strong performance was attributed in part to the fact that the country is less reliant on external trade than many of its neighbors, although lower confidence has led to a marked decline in exports and slower growth in 2000. The service sector is expected to strengthen in India this year, and agricultural production, forecast to reach record levels, should help compensate for lower external demand and industrial production. Industry body FICCI says, the buoyant economic growth will attract more FDI over the next few years mainly due to a relatively high economic growth rate by world standards and large untapped markets.



Top investment banker

According to Prime Database year-end league table, DSP Merrill Lynch has emerged as the largest investment banker in fiscal 2001-2002 by managing public, rights and international capital market operations worth Rs. 31,921 bn. In percentage terms, this works out to 89 percent of the total market of Rs. 35,876 bn. In absolute terms, of the 18 public offerings, DSP Merrill managed five. JM Morgan Stanley stood second, managing issues worth Rs. 16,527 bn (46.1 percent) amounting to three of the total offerings. In the segment of open offers and buy-back too, DSP Merrill had the largest share with Rs. 23,917 bn, closely followed by JM Morgan (Rs. 20,183 bn). Of the 101 open offers/buy-back issues, DSP managed 16 and JP Morgan nine. The list of top five large investment banks in terms of value of issues managed during last fiscal also includes Kotak Mahindra Capital Company Ltd. (Rs. 4,536 bn), ABN-Amro Securities India Pvt. Ltd. (Rs. 8,340 bn) and ICICI Securities and Finance Company Ltd. (Rs. 11,201 bn). In the case of international capital market offerings, DSP Merrill has been ranked as

the top investment banker, handling three out of the five issues. It handled Dr. Reddy's listing on the New York Stock Exchange. DSP Merrill also managed the country's first 100 percent book-building issue for Bharti Televentures.

Family business under threat

According to a study by McKinsey, the next 10 years will see most family-owned businesses coming under threat because of conflict of interests among members of families. McKinsey's Director Ashok Alexander says family-owned businesses must introduce best practices and lay down clear rules on governance and leadership. Around 80 percent of the Indian companies are family-owned. The study included 30 leading family-owned businesses in the country. "The family-owned businesses are giving lip-service rather than bringing in best practices. The study reveals that these Indian firms are severely threatened. Such businesses are moving towards third-generation ownership, the most critical phase. However, their counterparts in the West had been wiser in this regard and had introduced best practices. Only seven percent of the fully family-owned businesses have survived beyond the third generation. The study suggests that building leadership among family members and defining their roles within a family are the key to success. Also, family members who remain outside a business should not try to exert much influence.



Shakeout in television sector

The number of color television manufacturers in India would drop to six from a current 15 by 2005 as smaller players struggle to keep costs under control, says the Managing Director of Philips India Ltd., K Ramachandran. Apart from Philips, major color television manufacturers in the 5.3 million Indian market include BPL Ltd., Videocon International Ltd., LG Electronics Inc., Sony Corp. and Samsung Electronics Co. Ltd. Says Ramachandran, "I see a shakeout happening in the next three years." ■

International

Tech blues

The world's biggest computer company, IBM issued a surprise earnings warning, its first in more than 10 years, causing a 10 percent slide in its share price as hopes for a recovery in IT spending faded and dragged down the Dow Jones and NASDAQ stock indices. IBM's profit warning dashes tech recovery hopes. The first-quarter revenues would be at least \$1 bn below estimates. Earnings per share would be 66-70 cents a share compared with Wall Street estimates of 85 cents. Revenue is expected to be \$18.4 bn to \$18.6 bn, compared with consensus estimates of \$19.65 bn. Big Blue's bombshell affected other technology companies as investors pulled out of computer stocks and reassessed optimism earlier this year that corporations would increase their spending on information technology. Some analysts argued that the warning could signify larger problems. During its last analyst conference in January 2002, IBM had announced that some large customers had delayed purchase decisions but it expected those to be made in the most recent quarter. "This warning could be worse than it looks because IBM had been banking on those deferred purchase decisions to boost the first quarter, and it looks like they did not come through," says Bob Djurdjevic, chief analyst at Annex Research, a US IT consulting company.



Japan business sentiment 'flat'

It seems there is no end to the decade long Japanese recession. The business sentiment remained flat in the first quarter of 2002, disappointing economists who had been expecting the first improvement in 18 months, says the survey from the Bank of Japan. The figures may indicate that Japan's cyclical recovery could get off to a slower start than expected, in spite of the improvement in the US economy, the weaker yen and lower Japanese inventories. The survey closely watched diffusion index for large manufacturers, which remained steady at minus 38, indicating that for every 100 companies

Signs of turnaround

Most economies in the Asia-Pacific region have experienced a sharp fall-off in growth since 2000, but are now showing signs of a turnaround, says the International Monetary Fund in the *World Economic Outlook (WEO)*. Recent economic indicators have generally provided encouraging signs about the prospects for recovery. Increases in semiconductor prices, orders, and shipments over recent months, together with the broader strengthening of activity now appearing in the US and other advanced economies, will support export performance and industrial production in Asia. Production has already picked up in a number of countries including China, Korea, Malaysia and Thailand, as has consumer and business confidence. Financial sector indicators have also been generally positive. In particular, most equity markets have recovered from the September 11, 2001 shock and continued to rise in 2002, and bond spreads have declined to below their early September levels and shown little reaction to the turmoil in Argentina. Strong economic fundamentals have also allowed many regional economies to use macroeconomic policies in support of recovery, the report says.

The IMF projected that activity in almost all countries in the region is expected to pick up in 2002 and gain further strength in 2003. Among the newly industrialized economies, the recovery in global activity and in the electronics sector should support modest growth in Hong Kong SAR, Singapore, and Taiwan Province of China in 2002 following sharp downturns in 2001, and firmer growth is expected in Korea. The IMF forecasts that India, Pakistan and Bangladesh would grow respectively by 5.5 percents, 4.2 percent and 3.9 percent in 2002. Growth in China is expected to be about seven percent in 2002, supported by robust domestic demand. Meanwhile, growth in Australia and New Zealand has held up relatively well during the global slowdown.

that were optimistic, 138 were pessimistic. Many economists had expected the index to edge up to minus 36. The survey also indicated that Japan's large manufacturers intend to cut capital spending by 8.4 percent in the coming year, showing that expectations of a robust and sustained recovery are thin.

Profits fall to 9-year low

UK's manufacturing profitability was slashed last year to its lowest level in almost a decade as the global downturn hit demand and sharpened competition. Official figures highlighted the exceptionally hard time manufacturing has been facing. The country's profitability had been declining since 1998, depressed by the strong pound. The global economic slowdown forced businesses to cut margins still further while markets shrank. The Office National Statistics (ONS) says manufacturers' net rate of return fell to 5.5 percent last year, down from 8.7 percent the year before and a 1997 peak of almost 12 percent. Profitability was at its lowest since 1992. Service

businesses' rate of return fell by 0.7 percentage points to 13.2 percent last year, the lowest since 1995. The ONS says retailing and wholesaling had a good year, but profits elsewhere were weaker. Both sectors were hit by high energy prices. The profitability of UK continental shelf companies—oil and gas producers—fell slightly but remained historically high at 34.3 percent. Douglas Godden of the Confederation of British Industry, the employers' body, says "The decline in profitability of both manufacturers and service companies over the past few years presents one more reason not to add any more taxes on business." But manufacturing leaders complain the damage has already been done. They argue that years of low profits have forced manufacturers to abandon investment plans essential to their long-term competitiveness. By the final three months of last year, manufacturing investment was down by almost 10 percent. ■

N Janardhan Rao, Team Analyst

Merger street

Shell acquires Pennzoil-Quaker for \$3 bn

Royal Dutch Shell, the Anglo-Dutch oil giant, moved to strengthen its lubricants business with the \$2.9 bn acquisition of Pennzoil-Quaker State Company, the leading motor oil manufacturer. Shell is offering \$22 in cash per Pennzoil share, valuing the equity at about \$1.8 bn. Shell will also take on Pennzoil's debt of \$1.1 bn. The deal will make Shell a leader in the global lubricants brand, while also strengthening its US oil products business. Pennzoil is the world's leading independent lubricants company, boasting a range of well-known brands such as Jiffy Lube. Pennzoil-Quaker State was formed in late 1998 through the spin-off of Pennzoil's marketing, manufacturing and fast oil change businesses and its subsequent merger with Quaker State Corporation. Although the company has a leading position in its markets, it was generally viewed as too small to compete with larger integrated oil groups in the long-term. Shell has been hunting for an acquisition in the US for some time, although its recent efforts have concentrated more on producers of natural gas. Pennzoil-Quaker is one of the leading auto consumer products company with a substantial portfolio of auto and heavy machinery oil products. Salomon Smith Barney advised Shell, while Morgan Stanley advised Pennzoil.



Indian M&As in 2001-2002

Despite the slowdown in the economy there was a marginal pick-up in the quantum of merger and acquisition activity in India in the last fiscal. There were 1,344 M&A deals worth Rs. 35,360 crore announced in fiscal 2001-02 as compared to 1,477 deals aggregating Rs. 33,649 crore during the previous fiscal, according to the Centre for Monitoring Indian Economy. The new factor in fiscal 2001-02 was disinvestment, which made up for over 10 percent of the total amount. A pick-up in open offer and buy-backs also spurred mergers and

acquisitions. The number of open offers was the highest ever in the last three years with 98 open offers being announced in 2001-02 amounting to Rs. 4,788 crore of which 30 were by multinationals. Of these some 24 could result in delisting if the offer is successfully concluded. The remaining six were on account of change in management. Buy-back activity too spurted with 30 open offers during the fiscal, amounting to Rs. 2,509 crore. The Central Government was able to secure Rs. 3,881 crore through the disinvestment of its stake in companies and hotel properties, thus accounting for over 10 percent of the total quantum of M&A. The largest contributor towards M&A activity was the communications industry followed by chemicals and the financial services sector. Consolidation initiatives by Bharti, BPL and the Birla-Tata-AT&T combine saw M&A deals of over Rs. 7,000 crore. The chemicals industry, which includes pharmaceuticals, witnessed 198 deals aggregating Rs. 3,289 crore. Some of the high profile deals included the Rs. 256 crore acquisition of German Remedies by Zydus Cadila and Pharmacia's acquisition of Abbott for Rs. 91 crore. The financial services sector too saw increased acquisition activity in the latter half of 2001-02 led by the ICICI and ICICI Bank merger.

Deutsche Börse to buy Clearstream

Deutsche Börse, the owner of the Frankfurt Stock Exchange has acquired the approval of 83.2 percent of its shareholders for the takeover of Clearstream, the Luxembourg-based settlement house and depository. The company, which owned half of Clearstream, paid €1.6 bn for the balance owned by the 93 banks in the Cedel consortium. Clearstream will almost double Deutsche Börse's revenues, adding about €600 mn to the €760 mn Deutsche Börse reported for 2001, according to analysts. The announcement finalizes the controversial takeover, which prompted JP Morgan and UBS Warburg to threaten to remove their business from Clearstream. Deutsche



Börse has spent the past three months carefully ensuring the votes of other shareholders. Clearstream is one of two European international central securities depositories, the other being Euroclear, controlled by the Paris-based exchange Euronext. Last year Clearstream considered merging with Euroclear to create a pan-European clearing and settlement powerhouse similar to the Depository Trust and Clearing Corporation (DTCC) in the US. Deutsche Börse used its 50 percent of Clearstream to veto this option, drawing criticism from the European Securities Forum, a lobby group that argues that horizontal market structures are more efficient. Company sources maintain that the deal would create "a highly efficient, low-cost securities processing chain."

SCH to buy Santiago stake

Spanish financial group Santander Central Hispano (SCH) is to buy the Chilean Central Bank's 35.4 percent stake in local bank Banco Santiago after an attempt to sell the shares on local and international markets was called off due to lack of interest. According to the Chilean Central Bank there was strong interest from international investors in the auction, but not enough to "assure an adequate level of liquidity for the stock." SCH has an option dating back to May 1999, under which it is required to buy the stake if the Central Bank is unsuccessful in selling the shares before May 15, 2002. SCH already owns 43.5 percent of Santiago. The Central Bank's stake will cost SCH some US\$ 670 mn and will increase its exposure to Latin America, where it already controls 10 percent of the region's banking industry. SCH will increase its stake in Santiago to 78.9 percent through acquiring the Central Bank's stake and that is more than the 66 percent required to merge Santiago with SCH's other Chilean subsidiary, Banco Santander Chile. Although Santiago and Santander Chile are among the most profitable banks in Chile and the benefits from a merger would not be that great, SCH is likely to merge the two banks as part of its regional strategy to cut costs and increase efficiency as per analysts.

Cendant to buy two real estate firms for \$390 mn

CENDANT real estate giant Cendant Corp announced that it would buyout NRT Inc. from its partner in the joint venture and also acquire Arvida Realty Services. The company also said that it would pay \$230 mn to buy NRT from Apollo Management, and would take on about \$300 mn of debt, which it will retire. NRT, a residential real estate broker with 850 offices and 45,000 agents, was a joint venture started by Cendant and Apollo in 1997. Cendant also said its NRT unit will acquire for about \$160 mn cash Florida-based Arvida, a residential real estate brokerage, from The St. Joe Co. Combined, the two deals are expected to add to Cendant's 2002 earnings by 2 cents a share, as per company sources.

BP to increase stake in Sidanco

BP is to spend \$375 mn (£260 mn) to increase its stake in Sidanco, the Russian oil company, from 10 to 25 percent, in a move that underlines its "confidence in Russia's improving business environment". BP is buying the extra Sidanco shares from Alfa Bank of Moscow and Access-Renova, a US-Russian investment group, with which it has had a bitter wrangle. In 1997, BP paid \$484 mn for 10 percent in Sidanco, only to see that company's chief asset, the Chernogorneft oil field, disappear into the hands of Tyumen Oil (TNK), also controlled by Alfa and Access-Renova, in a controversial bankruptcy case. Last year, BP got Chernogorneft returned, and had its contract to manage Sidanco renewed for another three years. Since then it has been negotiating for a bigger equity stake commensurate with the management time and effort it has put into Sidanco. The deal could be a stepping stone towards further investment moves by the UK-based oil group. Alfa and Access-Renova still control 56 percent of Sidanco.



TRW board rejects \$6.7 bn takeover bid

Defense contractor and auto parts maker TRW Inc. advised shareholders to reject Northrop Grumman Corp.'s sweetened \$6.7 bn takeover offer, calling the US defense giant's bid financially inadequate.



TRW said its board unanimously voted to reject the hostile \$53 per share, all-stock bid, which Northrop submitted after revising its initial \$47 per share offer. TRW's board said the new offer "continues to undervalue TRW's business and its opportunities," and said the company's current plan to accelerate its debt reduction and spin off its automotive parts business would offer shareholders more long-term value. The shareholders are to meet on April 22 to vote on whether the board should pursue the transaction.

Centrica strengthening its hold in US

The invasion of North American energy markets has taken place with Centrica, UK's biggest gas and electricity supplier purchasing two Texas-based power suppliers from American Electric Power (AEP). Centrica has agreed to pay \$133 mn to \$153 mn for the two companies, Central Power and Light and West Texas Utilities, which supply 850,000 residential and small business customers. AEP will continue to own the power stations and transmission networks delivering electricity to Centrica's Texas customers. Texas is one of the few US states going ahead with energy liberalization after the Californian power crisis and the collapse of Enron. The deal cannot be completed until July without AEP falling foul of accounting treatment rules triggered by its merger in 2000 with rival US power group Central and South West Corporation. The selling price to Centrica will be finalized when the Texas sales can be completed. The sale by AEP of Seaboard, the UK electricity supplier, has also been delayed for the same reason. Centrica entered the North American market in 2000 when it paid £406 mn (\$586 mn) to buy Direct Energy, the Canadian energy supplier. It wants to have 10 million North American customers by the end of next year. It currently supplies gas to 900,000 customers and electricity to another 400,000, two-thirds of them in Canada. A further 600,000 electricity customers have agreed to switch to Direct Energy when Ontario opens its power markets to competition next month.



EU clears \$6.4 bn Bayer deal

Bayer AG won a green light from the European Commission for its €7.25 bn (\$6.38 bn) purchase of Aventis CropScience, on condition it divest product lines worth €600 mn. The acquisition will boost Bayer's crop-protection business to the number-two spot in the \$30-bn-a-year worldwide agrochemicals market, behind Switzerland's Syngenta AG. Bayer now ranks seventh. For France's Aventis SA and Schering AG of Germany—which has 24 percent of CropScience—the deal represents a strategic refocusing on higher-margin pharmaceuticals. After a four-month investigation, the European Union's competition watchdog concluded that the deal as originally structured would have been anti-competitive, but spin-offs of certain products—notably insecticides—agreed by Bayer made it acceptable. Both the Commission and the United States have been reviewing the transaction to ensure that the combined firm will not dominate any one of the many markets it supplies. Bayer said it expected clearance from the US Federal Trade Commission shortly.

Deal drought and investment banks

JP Morgan Chase and Merrill Lynch reported declines in first-quarter earnings reflecting the deal drought on Wall Street and other bear market factors. JP Morgan's net income in the quarter fell 18 percent from last year to \$982 mn (£682 mn) its eighth straight quarterly decline. Merrill's net earnings were \$674 mn, down 26 percent from 2001. The results compound a run of bad news for both banks. JP Morgan is fending off criticism that it helped Enron disguise the extent of its debts. Merrill's research analysts have come under fire from the New York state attorney-general for recommending stocks they privately disparaged. Lack of mergers and acquisitions hit both companies. Advisory revenues fell 44 percent to \$191 mn at JP Morgan and 35.6 percent to \$183 mn at Merrill. ■

DG Prasanna, Team Analyst

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About: BIS	The Bank for International Settlements (BIS) is an international organization which fosters international monetary and financial co-operation and serves as a bank for Central Banks
BIS Profile	The BIS acts as: • A forum to promote discussion and facilitate decision-making processes among Central Banks and within the international financial community,
Board and Senior Officials	• A center for economic and monetary research; • A prime counterparty for Central Banks in their financial transactions,
BIS History	• Agent or trustee in connection with international financial operations The profile describes BIS, its work, and that of the various groups operating through the BIS.
Legal Information	• Organization and governance. • Forum for international monetary and financial co-operation
BIS shares withdrawal	• Center for monetary and economic research. • Bank for Central Banks.
Press and Speeches	• Agent and trustee Functions
Press Releases	The BIS functions as: • A forum for international monetary and financial co-operation where Central Bankers and others meet and where facilities are provided to support various committees, both standing and ad hoc;
BIS Speeches	• A bank for Central Banks, providing a broad range of financial services;
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Central Bank Websites	• An agent or trustee, facilitating the implementation of various international financial agreements
Articles and Speeches	The BIS operates the Financial Stability Institute (FSI) jointly with the Basel Committee on Banking Supervision. The BIS also hosts the secretariats of the Financial Stability Forum (FSF) and the International Association of Insurance Supervisors (IAIS).
Banking Services	Banking Services Among its corporate objectives, the BIS is committed "to serve as a prime counterparty for Central Banks in their financial transactions, by providing an appropriate range of banking services and maintaining its reputation for absolute confidentiality and security."
BIS as a Bank	The BIS accordingly offers a wide range of banking services specifically designed to assist Central Banks in the management of their foreign exchange and gold reserves. The BIS also acts as a banker to, and manages funds for, various international financial institutions.
Balance Sheet	The BIS does not accept deposits or is permitted to make advances to governments or open current accounts in their name.
Forum for Central Banks	Forum for Central Banks
Committee on Payment and Settlement Systems	The BIS provides a forum to facilitate co-operation between Central Banks on policy issues relating to monetary and financial stability. Most of the related activity is prepared, co-ordinated or implemented by the Bank's Monetary and Economic Department. One important function in this regard is the provision of Secretariat Services for the various committees and working groups of Central Bank officials who meet on a regular basis to work on particular policy issues. Such services are also provided for ad hoc meetings of senior Central Bank officials organized by the BIS on specific topics of interest to particular Central Bank constituencies. A number of
Committee on the Global	

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Financial System	regular meetings for Central Bank governors and senior Central Bank officials take place on the occasion of the meetings of the BIS Board. Meetings for senior Central Bank officials are also organized in Basel as well as in other regions of the world on specific issues such as the operation of monetary policy, the structure and functioning of financial systems or international financial market developments.
Research Activities	
Other activities	In addition to the specific tasks to support the various committees and groups of experts, the Monetary and Economic Department conducts research and policy analysis to support the activities of the Central banking community working with the BIS.
Basel Committee	Finally, the Department encourages the smooth exchange of information amongst the Central banking community participating in its various activities. This includes the development, maintenance and operation of various databases covering a wide range of topics such as macroeconomic and international financial statistics; institutional arrangements underlying Central Bank operations, and information concerning technical assistance and training for Central Banks from transition economies.
About Basel Committee	
Basel Capital Accord	
Publications	Basel Committee The Basel Committee, established by the Central Bank Governors of the group of ten countries at the end of 1974, meets regularly four times a year. It has about 30 technical working groups and task forces which also meet regularly.
Financial Stability Institute	The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their Central Bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the Central Bank. The present Chairman of the Committee is William J McDonough, President and CEO of the Federal Reserve Bank of New York.
About FSI	
Activities	The New Basel Capital Accord In December 2001 the Basel Committee on Banking Supervision announced a revised approach to finalizing the New Basel Capital Accord and the establishment of an Accord Implementation Group. Previously, in June 2001 the Committee released an update on its progress and highlighted several important ways in which it had agreed to modify some of its earlier proposals based, in part, on industry comments.
Publications and Statistics	
Regular Publications	
BIS Papers	In January 2001 the Basel Committee on Banking Supervision issued a proposal for a New Basel Capital Accord that, once finalised, will replace the current 1988 Capital Accord. The proposal is based on three mutually reinforcing pillars that allow banks and supervisors to evaluate properly the various risks that banks face. The New Basel Capital Accord focuses on:
Committee Publications	• minimum capital requirements, which seek to refine the measurement framework set out in the 1988 Accord • supervisory review of an institution's capital adequacy and internal assessment process • market discipline through effective disclosure to encourage safe and sound banking practices
Working Papers	
International Financial Statistics	Financial Stability Institute The Bank for International Settlements and the Basel Committee on Banking Supervision jointly created the Financial Stability Institute (FSI) in 1999 to assist supervisors around the world in improving and strengthening their financial systems.
Other Publications	
What's New	Financial stability is crucial for sustained economic growth and cannot be achieved without strong financial systems. Weak financial systems can destabilize local economies, making them more vulnerable to external shocks, and may threaten global financial markets.

PERSPECTIVE

Tangible Assets

Inherent virtues

The burst of the dotcom bubble has proved that the essence of intangible assets lies in the strength of the real sector.

The growth of the Internet and the hype about the new economy has prompted many management gurus to lay a strong emphasis on building strong intangible assets. The essence of their argument is that companies should build competencies in areas such as design, supply chain management and brand building and leave the 'dirty' job of constructing and running factories to contractors. Indeed, the stellar performance of companies like Cisco and Enron in the 1990s, provided strong support for this argument. With the fall of Enron, which burnt its fingers while attempting to convert itself from a brick and mortar to a new economy outfit, this argument looks very weak. On the other hand, the good old 'smoke stack' companies, with their physical assets look safer to investors, even if they do not offer superlative returns.

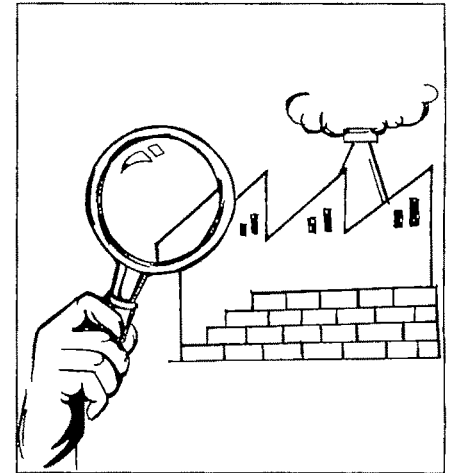
In their enthusiasm to propound the virtues of intangible assets, what consultants and academics seem to have forgotten is that life cannot go on without physical goods. The brush and paste with which we start the day, the morning coffee we have, the breakfast, lunch and dinner we eat all involve 'tangible' items. We ride to the office in 'physical' vehicles. A modern office consists of 'physical' assets such as chairs, tables, workstations, air-conditioners and coffee vending machines. True, we do consume services such as Internet access, banking, courier and haircuts. But if we carefully reflect, we would realize that we consume much more of goods than services. This argument is applicable to both developing and developed countries. In developed countries, services account for a major portion of the GDP. But this does not imply that people in these countries do not need

physical goods. It only means, physical production has shifted to low wage locations. The point to note is that someone has to manufacture goods. The entire world cannot operate on a 'virtual' paradigm!

When Enron decided to move out of electricity generation into electricity trading, it thought it was being smart. Indeed, before its recent collapse, it was quite arrogant towards the bigger companies in the energy industry, which owned a lot of physical assets. Former Enron CEO, Jeff Skilling once commented (*Fortune*, December 24, 2001) on old economy companies, "These big companies will topple over from their own weight." Today, Enron has toppled but many of these old economy companies still exist! Moreover, companies like Cisco, which have been considered the ultimate experts in strategic outsourcing and supply chain

management were left clueless when the US technology sector recently went into a slowdown. This forced them to take massive write-offs.

A point often overlooked is that it is usually much easier to evaluate the quality of physical assets than of intangible ones. Physical assets can be valued with a fairly high degree of accuracy using different methods such as book value, market price or replacement cost. But valuation of intangible assets like brands involves several assumptions, which often turn out to be wrong. In many cases, there is a huge gap between projected and actual cash flows. Moreover, the accounting practices of companies built around intangible assets are often controversial. For example, AOL capitalized its advertising expenditures for several years arguing that they were capital investments. The dividing line between



expenditures, which will yield a one time benefit and those which will yield benefits over a period of time is extremely thin. In the case of the 'smoke stack' companies on the other hand, accounting practices can be much more transparent.

It is time to take the brick and mortar companies more seriously. These companies may not look that glamorous. They may also not achieve super normal growth rates. But they are safer bets. They have physical assets like real estate and plant and equipment, which cannot evaporate even if the markets crash! These assets can generate cash during bad times. And cash, as we all know, is the ultimate hedge against risk. But intangible assets such as corporate reputation can vanish overnight if things go wrong. This is exactly what has happened with many of the new economy outfits. So, has the time come to say "Three Cheers" to the brick and mortar companies? ■

AV Vedpuriswar, Dean,
ICFAI Knowledge Center, Hyderabad

Reference # 1-2002-05-01

POTO

TADA's prototype

The new law against terrorism, POTO, has evoked consternation among India's intellectual elite. There is a fear that like TADA, it will also victimize innocent people.

Enacting laws cannot solve problems, nor can problems be solved by providing for a different and more drastic procedure for prosecution of certain crimes. Terrorist groups are using modern technology with ruthlessness in eliminating their adversaries. The agencies fighting them need strong laws and proper equipment to deal with them. Terrorists have rendered over five lakh persons homeless in our country and 54,000 lives have been lost in the last 15 years.

The Terrorists and Disruptive Activities (Prevention) Act (TADA) had become so discredited that no government could think of extending or reviving it. After its lapse in 1995, the Union Cabinet approved on October 16, 2001, the Prevention of Terrorism Ordinance (POTO). The explanation given by the Indian Government for implementing POTO was that after September 11, terrorism has attained global dimensions and India has to comply with the United Nations Security Council Resolution 1373 of September 28, 2001, enjoining member-states to undertake comprehensive measures to deal with terrorism. The battle against terrorism is justified because terrorists are following the path of violence mercilessly.

The main argument about the anti-terrorist legislation is that it is not that there is an intention to misuse it, but that there is a possibility of such misuse. Its predecessor, TADA had a long reign of 10 years, from 1985-1995. It was the most misused and abused anti-civil liberties legislation since independence. POTO also faces possibility of such misuse. The Congress party was instrumental in creating a host of dreadful laws like: PDA, DIA, MISA, NSA, TADA etc., in the past and these Acts were misused by the party to suit its political contingencies.

POTO defines terrorism as: "An act done by using weapons and explosive substances or other methods in a manner as to cause or likely to cause death or injuries to any person or persons or loss or damage to property or disruption of

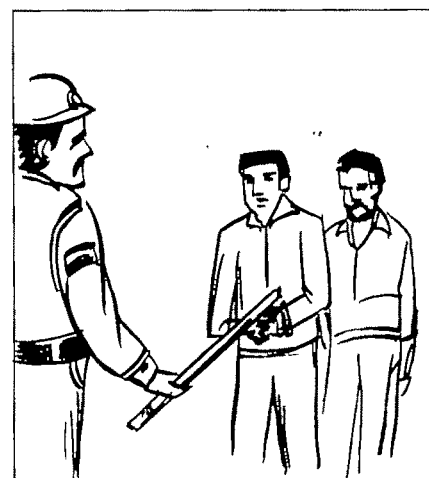
essential supplies and services or by any other means necessary with intent to threaten the unity and integrity of India or to strike terror in any section of the people."

Section 3(1) of the Act defines a terrorist as somebody with the "intent to threaten the unity, integrity, security or sovereignty of India or to strike terror in the people..." who commits violent acts by "using bombs or other explosive substances or... other... poisons" etc., to cause death, injuries, or damage to, "property or... supplies"... to be used "for the defense of India ...".

We already have the National Security Act, the Unlawful Activities (Prevention) Act, and the Armed Forces Special Powers Act that are sufficient to deal with any situation thrown up by terrorists. The maximum punishment for committing a terrorist act is death, and the minimum punishment is five years' imprisonment. If the Government had wanted to term terrorism as an offense, it could have done so by making it as an offense under the Indian Penal Code (IPC). Under our Constitution, acts of violence like murder, arson, bomb-blasts and even hijacking can be dealt with under existing laws.

The question that arises in the mind is—was there a need for POTO? It is sad that POTO, like its predecessor TADA, is perceived as an additional instrument of state harassment. Under POTO the Government has banned 25 organizations. It is really a big question whether it can actually stop or reduce terrorism. It even covers or rather compels journalists to disclose all information regarding any person or persons perceived by the police as terrorists, with provision for imprisonment from a period of one year to 10 years for failure to do so. Under POTO bail is denied to an individual until he is found not guilty.

POTO has evoked consternation in India's political and journalist world. It is not that we do not need to fight terrorism, but the fear is, like TADA it will victimize innocent people through unwarranted detention and harassment,



promote irresponsible policing, and thus damage the credibility of the legal system. This in turn can only lead to more discontent and aggravate the phenomenon of sub-state terrorism, which actually POTO is meant to fight. POTO has thus become a harsh preventive detention law, which reverses the burden of proof and permits the harassment of anyone the government considers undesirable. The government can tap or intercept any communication, including electronic, wireless, oral or other messages from anyone suspected of indulging in a terrorist offense. The intercepts are admissible as evidence in court. This provision can easily be used for harassing and intimidating political opponents. Laws such as POTO give the police the option of not investigating crimes and painstakingly gathering evidence. Mere suspects can be charged with "terrorism" and detained for years. It is ironic that our law enforcement agencies have become notorious for their bias. A government's fight against terrorism has to be accompanied by checks on law enforcement agencies. It would be ironic if a law that seeks to attack terrorism ends up terrorizing the innocent. ■

Dr. Ajit Kumar, Faculty, ICFAI

Reference # 1-2002-05-02

TICKER

Maruti Udyog Limited, the country's major car manufacturer was in the news recently, thankfully for all good reasons. The company, after a string of losses for the last couple of years, has bounced back to profit making ways in the fiscal 2001-02. The company posted profits of around Rs. 55 crore during the financial year as against a loss of Rs. 269 crore in the previous fiscal. Another reason why the company has been in the news for some time now is that the Government after dabbling for long has finally decided to go for divesting its stake in the company in favor of a suitable partner, most probably the Suzuki Motor Corporation of Japan.

This PSU, which is a joint venture between the Government of India and Suzuki Motors of Japan, once enjoyed the status of near monopoly with a 70 percent market share. But with the entry of several foreign carmakers in the domestic market, the ride has not been a smooth one for this home-grown company. Another problem that has been distracting its focus in the last several years is the dispute between the Government and Suzuki over the stake sale. This also added to the shrink in the market share of the company, as it was unable to take on the competition in equal measures (i.e., by bringing better models into the market).

Maruti Revs Ahead

Some of the major reasons for the company's turnaround include its aggressive roll-out of many new variants (like Versa, Baleno, Alto, and Wagon R) across categories such as mid-range, small-range and Small Utility Vehicle (SUV), aggressive brand promotions, introduction of special variances of Maruti 800, etc. This apart, the company adopted several innovative production practices and systems, which improved the quality substantially. Optimum utilization of production lines, outsourcing of low value added jobs and substantial reduction in material handling also led to improved productivity. It also started the restructuring of its human resource to reduce the extra workforce and increase the efficiency level.

Financial restructuring also helped the company to a great extent to return to profitability. Maruti's financial strength helped it to obtain funds below the Prime Lending Rate to meet its short-term borrowing requirements. Lower yen rate was one of the prime reasons for lower cost of the company. The results are definitely going to give a strong boost to the disinvestments process of Maruti. And the sooner it happens the better it will be for this ubiquitous car major.

Sharad Mishra

Infosys Technologies, the Indian software bellwether has managed to exceed its own revenue and earnings guidance. For the quarter that ended on March 31, 2002, Infosys posted a 16 percent rise in net profit to Rs. 210.32 crore (Rs. 181.57 crore) on an income of Rs. 680.13 crore (Rs. 561.87 crore). For the full fiscal up to March 2002, net profits rose by 28.5 percent to Rs. 808 crore on a 37 percent rise in total income to Rs. 2,600 crore. The contribution from Infosys' top five customers was 24.4 percent as compared to 24.1 percent in the last fiscal, with the top 10 contributing 39 percent as against 38.3 percent in the last fiscal and only two clients accounting for more than five percent of revenue. The company has one of the most derisked modes, and this diversifies the revenue stream and reduces the dependence of the company on any particular clients. The addition of new clients, 29 of them this time, which are an imperative to maintain future growth momentum, is healthy.

The operational performance during the fourth quarter was marked by pressure on Operating Margins (OPM) due to the pricing factor, addition of 29 new clients and good volume growth. Moreover, the initiatives for Business Process Management (BPM) and IT outsourcing were launched and marketing of systems integration services began during the quarter. The board has recommended the

approval of the members in the ensuing annual general meeting and a resolution for increasing the maximum limit of Foreign Institutional Investors (FII) investments in the company to 100 percent of the paid-up equity share capital of the company.

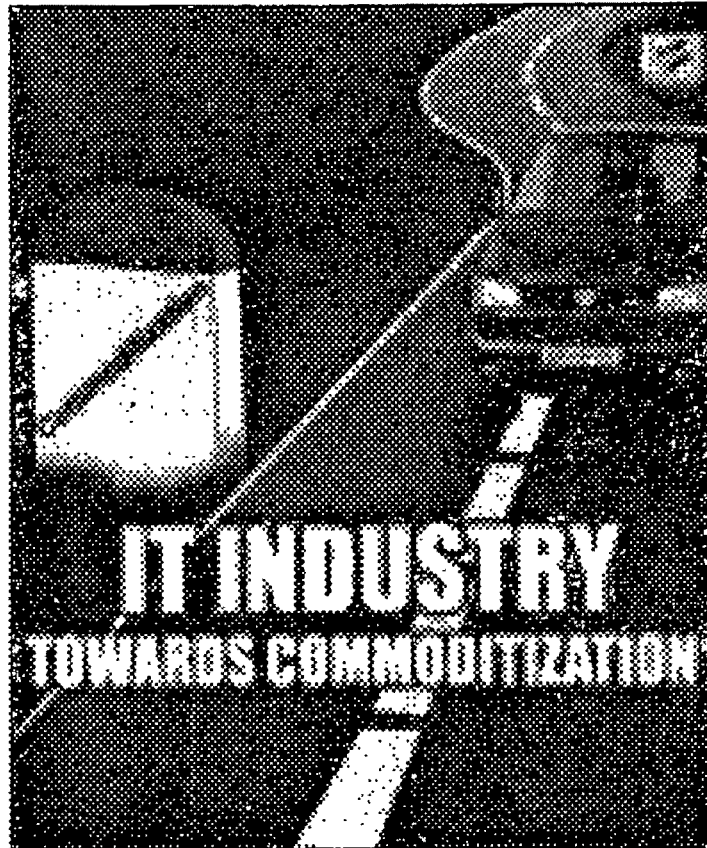
When the quarter ended on March 31, 2002, the Company swapped 55,00,000 common stock in Yantra Corporation, USA (Yantra) for a fully paid warrant. Accordingly, Yantra is no longer a subsidiary of the Company as per the Companies Act, 1956 as on March 31, 2002. There were no investments during the quarter that ended on March 31, 2002. During the quarter that ended on June 30, 2001, the company invested Rs. 103.20 mn in Workadia, Inc., USA (Workadia) purchasing 22,00,000 fully paid Series B convertible preferred stock, par value of US\$ 0.0002, at US\$ 1.00 each (adjusted for stock splits). Workadia is involved with providing comprehensive customizable business Intranets through browser accessed hosted portals and also offers consulting services to help customers select and deploy their Intranet applications, content, and services.

Infosys
POWERED BY INTELLECT
DRIVEN BY VALUES

Infosys Exceeds Expectations

Abhishek Agrawal

IT Industry: Towards Commoditization



Price considerations have played a major role in eroding product differentiation in the IT industry. In the West, it is quality and the features of the product that drive the purchasing decision. However, in the case of developing countries like India, price considerations have always played a crucial role in influencing consumers' decisions, ceteris paribus. With new entrants in the marketplace, bringing in products with similar features yet with limited price differences, competition has intensified. With increased price wars and continuous technological progress, the industry is moving towards commoditization. Commoditization, today is akin to a strong tidal wave sweeping all the segments of the IT sector. Some sectors like hardware, which were relatively weak, were washed off earlier. And other foundations like the software sector are witnessing the blow now.

TOWARDS COMMODITIZATION

"We understand that the only competitive advantage the company of the future will have is its ability to learn faster than its competitors."

—Arie DeGens of Royal Dutch/Shell

When Michael Dell, a 19-year old college dropout, planned to build Dell Computer Corporation in 1984, with a start-up capital of \$1000, the first seeds of commoditization were sown in the technology business. The IT industry, where a few limited brands like HP and IBM ruled the roost, was never easy to enter for a new player as entry barriers were high. But the gradual transformation of the industry towards following a standard platform, that steadily eliminated product differentiation, fostered commoditization. Though companies like IBM had their own de facto market share, systems technology started becoming vendor-specific. In the eighties, IT companies tried to maintain a straggling bondage by uniquely bundling hardware and software products before packaging. This created a market where different parts of the computer were assembled and sold at a price cheaper than the branded companies. For example, Dell did not produce computers; it only assembled the software, the hardware and the monitor and marketed it. Following the footsteps of Dell, various other computer vendors, like Gateway and Compaq, dived into the business. This outsourced-based model gradually transformed a product into a commodity. Commoditization, which is a natural outcome of intensive competition and technological progress, appeared to be evident in the IT sector.

As more and more competitors entered the technology business, profit margins started dwindling and the scope

of product differentiation diminished. Increased competition gradually led to companies producing similar products at lower costs. This turned in a market very similar to the telecom or automobiles industry.

However, both enterprises and consumers required the assurance that the products of the different vendors did not require massive reinvestment. Bypassing the dominant system of using computer vendors to sell mass-produced computers, Dell started the trend of selling custom-built computers directly to end-users. This model eliminated resellers, retailers and other costly intermediary steps together with the industry's most efficient procurement and distribution process. Though Dell was built on the foundations of commoditization, ironically, it became a strong brand. Losing the fight, the market giants in the PC segment like HP and IBM, surrendered to the low-cost leader. Since then, commoditization has continued to dominate the industry.

Brand equity vs. price

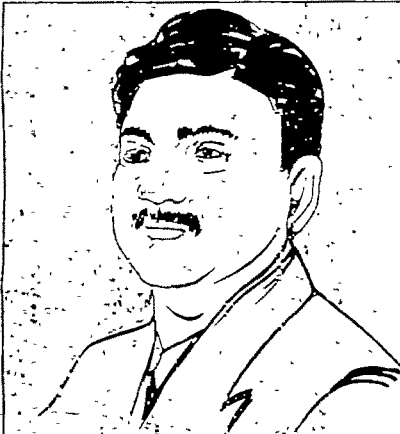
Probably, it was because of commoditization that global majors were experiencing negative growth as the US economy went into recession. Dell was the only company that was sitting pretty on profits. This was reflected when the worldwide PC market experienced negative growth for the first time since 1986. Among the global vendors, barring Dell, which recorded a rise in its quarter-on-quarter growth, all the other major vendors saw a sharp decline in their PC shipments. The worst hit was Compaq. With a positive growth, Dell managed to grab the number one position by toppling Compaq. Comments Dr. Ashok Jhunjhunwala, Head, Telecommunications and Computer Networks group (TeNeT) at IIT Madras, "For large corporate/

institutional customers and about two percent of homes, brand is important. For middle and small size business and 98 percent of homes, the price and utility is most important. Affordability is the key. Branded products, if not affordable, will not be used."

However, Ravindra Datar, Senior Analyst—IT Services, Gartner India Research & Advisory Services, feels, "Branding is still very important in every business including the technology business. Without brand recognition and brand value one's range of products and services becomes indistinguishable from those of other vendors and the competition focuses solely on price leading to a fierce price war that bleeds everyone involved." Disagreeing with the idea that brand erosion is taking place in the technology sector he notes that it is becoming increasingly important to build strong competitive differentiators and use these to build brand value to make one's business relatively immune to pressures on pricing. It is important to be able to convince the buyers that they should be looking beyond cost. In the complex global markets, where low price can be easily matched or surpassed by an aggressive competitor, it is a strong reputation and brand recognition that will help companies build sustainable competitive positions in the global markets.

Emphasizing on the brand strength Ashok Kumar, MD, Lotus Strategic Consultants Ltd., Mumbai, opines that had it not been for strong brands like Dell, and IBM, it would not have been possible for these companies to achieve such astounding success in technology business. He observes, "One would guess that Dell's Direct Access Model (DAM) is damning all other vendors in the business. Dell, with its aggressive pricing and direct model continued to increase its market share at the cost of Compaq, while IBM piggybacked on its strong services and 'e-server' strategy that helped it to increase its global market share."

However, the Indian scenario is totally different with pricing becoming a crucial factor. The hardware industry, which is dominated by the unorganized sector (comprising mostly of very small outfits, which assemble readily available parts), has little space left for the branded players. The numbers speak for themselves: The unorganized sector presently has around 60 percent market share. The remaining 40 percent is shared



"Commoditization of a service-oriented industry like IT is not possible and a small drift towards commoditization due to a slight change in the market scenario does not reflect that the entire industry is heading towards commoditization."

Manoj K. Agarwal,
Director, IHT Network Ltd.,
Noida, India

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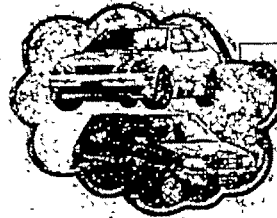
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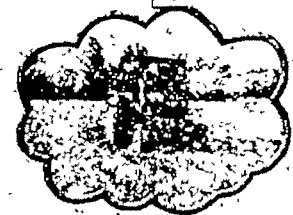
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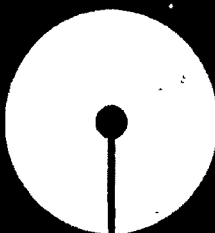


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TOWARDS COMMODITIZATION

between the MNC (23 percent) and the Indian brands (17 percent). Due to lower prices the unorganized sector has managed to dominate. These players manage to buy the components at lower prices, possibly without paying any taxes at all. And, once the assembled computer is sold they also manage to avoid the excise duty. "This gives the unorganized sector leverage as compared to the branded industry," says Kumar.

Hence, it is the sheer cost competitiveness that is providing the unorganized sector an edge over the branded products. Another reason for the preference of assembled products in a marketplace like India is the purchasing power of the consumers. Notes Jhunjhunwala, "Affordability in India is very different from that of in the west. Most IT manufacturers do not consider this." As most of the branded products are highly expensive compared to those sold by the unorganized sector, it makes sense for a price-conscious consumer to buy an assembled PC, ignoring the other superior benefits (if any) offered by a branded product, which are hardly put into daily use.

This is a phenomenon typical to a country like India. The reason lies in the economic condition of consumers who largely belong to the middle class. As the trade-off between purchasing power and the prices of PCs is very less, there is only one decisive factor that determines sales, i.e., price of the product. However, had the prices been quite less compared to the income or purchasing power of the consumers, perhaps, they would have preferred branded products. This has largely encouraged commoditization in the industry. According to Professor Madhubhanda Bhattacharyya, Indian Statistical Institute, Bangalore, "The household sector still prefers to buy



"The Indian workforce is very technology savvy, skilful and can easily adapt after requirement-specific training is provided. So India should take the risk of the product market in a phased manner."

*Prof. Madhubhanda Bhattacharyya,
ISI, Bangalore*

assembled computers, because of the price difference (although there is some attempt to bridge the gap) and relative flexibility."

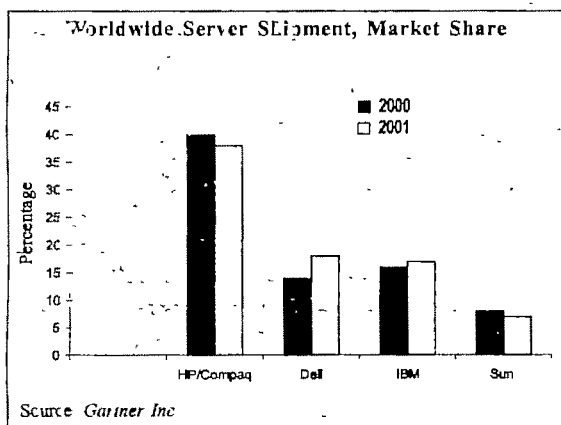
Manoj K Agarwal, Director, IIHT Network Ltd., Noida India, says, "Branding in the case of technology business gives certain amount of confidence to the buyer about factors like, after-sales service, availability of spares in future, technical support (Help Desk), upgradation in future and above all it gives a feeling of 'getting the same for which paid'." This is very important, especially in the segments where awareness about technology is low. In countries like India, where technology has reached the users much before the awareness about the same, he feels that it is very important to buy branded products from the "true technical company" which helps the user in getting the right product as the requirement and not on the basis of budget only. Drawing a strong analogy, Agarwal points out, "In the actual user segment, everyone is using the same 'knife' irrespective of the fact whether one has to chop 'vegetables' or 'meat'. The IT solutions/systems are not sold on the basis of the requirement of the user but on the basis of the budget of the buyer. This is due to the fact that majority of the sellers are even unable to analyze the true requirement of the user versus machine/solution." In such a scenario, branding, technical assistance etc., can play very major roles, provided users are informed in this direction.

Similar is the scenario in online markets and with Internet customers. Although price-cutting is becoming a

reckoning phenomenon of online markets, branding still maintains a key feature for Internet consumers. Argues Professor Prithviraj Dasgupta, Computer Science Department, University of Nebraska, Omaha, "Established brands with proven reputation are likely to attract more consumers than unknown or less reputed brands that offer low and attractive prices." An example of this in the online book purchasing market could be Amazon Inc. (<http://www.amazon.com>). A comparative search on the top five book titles in the New York Times bestseller list reveals that Amazon.com charges slightly higher prices than less reputed online merchants for each of these titles. However, Amazon.com compensates for the number of buyers it loses due to the higher price by having a dedicated customer base who always purchase from Amazon. Moreover, it has an excellent reputation as an online merchant, which is essential in a partially secure environment like the Internet where there is no physical interaction between the consumer and the seller.

The technology sector is also showing a similar trend. Brand names such as Dell and Gateway still charge slightly higher prices, as their Website stores reveal, than unknown or less reputed brands. According to Dasgupta, "The reason for this is that, well-known brands are guaranteed to attract at least some customers by virtue of their reputation. Therefore, although price-cutting has been an ongoing trend since the inception of e-commerce, price-based competition alone cannot replace brand reputation." Quality of the product and the features provided thereby also make a significant difference.

Undoubtedly, it is debatable whether well-known brands are better



performing than the unorganized sector. Price still looks to be a decisive factor in developing countries where markets are not mature enough with the IT industry facing increasing challenges of commoditization. Over a period of time, as markets grow and mature, only quality sells. Certainly, brand ensures the protection of the quality of the product and price. If the price becomes a decisive factor, it might affect the quality also.

Implications of commoditization

Wherever the tidal wave of commoditization sets in, rapid erosion of margins is the first impact on the vendors. In the absence of any major differentiation, cost becomes the only differentiator leading to fierce price wars that harm all the vendors in the long run. There is also the possibility of sub-standard products and services being sold at lower prices by unscrupulous vendors, thereby harming the credibility and margins of other serious vendors in the business. But selling sub-standard products and earning windfall gains, can only be a short-term strategy to survive in the market. Adds Datar, "The cost of marketing and selling products and services are also higher in a commoditized market, further affecting the bottom line of the vendors. Moreover, in an effort to minimize competition, there will be the threat of aggressive mergers and acquisitions in a commoditized market. This is especially true when the market is not growing at a pace that ensures sufficient business for everyone.

In the Indian context, the dominance of the giant companies, like Microsoft, IBM and Dell, is leading towards commoditization. Asserts Ashok Kumar, "It is very difficult to imagine why a large Fortune 500 company that uses say

KPMG for its audit, consulting, investment banking, environment management, quality control and a host of other services should shift to an Infosys unless they are offered a significant price reduction." Soon the global biggies will add development centers in India to match costs (they are already doing so). Again commoditization follows. Add to that high-end players like IBM and HP getting into consulting and it starts resembling a mad scramble for business.

As commoditization grows, this will lead to an end of monopoly power. "It will open up the market to more competition and last but not the least, help in establishing standards across the industry," says Dasgupta. This will encourage manufacturers across different sectors of the IT industry to develop compatible products and thus, promote growth in the industry as a whole.

Hard-hit hardware

The IT hardware sector can be segregated into at least two parts, one being the low-end computing machines with largely standardized configurations across vendors and the other being high-end computing machines built for specialized applications. Beyond these two, one also needs to take into consideration products like microprocessors that are used to build these machines. Says Datar, "In case of microprocessors, there is a lot of brand consciousness even among end-customers largely due to the brand building initiative by a major vendor of microprocessors." While cheaper versions may be available, one still sees customers looking for that particular logo when they buy a computer.

However, for the very high-end computing machines, though cost is a deciding factor, other factors such as the ability to meet specific functionality requirements is also important, rather more important, in most cases. "At that level one sees higher brand loyalty with little scope for commoditization," asserts Datar.

While some kind of commoditization is happening in the low-end computing machines, the trend of commoditization being valid for high-end machines is rather minimal, though rising. The low-end machines are largely

"It is the volume and ease of access for everyone to the technology from the point of cost effectiveness which is behind increased commoditization."

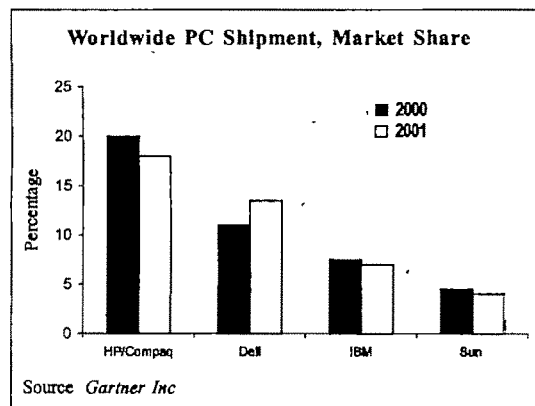
*KR Trilokekar, Vice-President,
DDE ORG Systems Pvt. Ltd.,
Bangalore*

used for standard applications and have standard configurations to be able to perform those operations, giving rise to scope for commoditization where one vendor's product could be indistinguishable from another if the brand label is covered. This is also the reason for a flourishing gray market for these kinds of machines where cost is a major decisive factor.

Price plays a major role in buying such machines where configurations are largely similar, making brand-based premium pricing difficult. While a few major brands do appeal to certain kinds of customers who might be willing to pay a premium to buy a recognized brand, at a broad level, the market is getting commoditized.

Though brands provide the customer a sense of quality assurance, the unorganized sector of today, is equally equipped with the latest technological developments to convert the hardware industry from a product to a commodity. It is always the element of quality that a consumer looks for, in a branded product. Over years, the unorganized sector has proved that brands like IBM or Compaq can hardly provide features significantly better than assembled products. Asserts KR Trilokekar, Vice-President, DDE ORG Systems Pvt. Ltd., Bangalore, "It is the volume and ease of access for everyone to the technology from the point of cost effectiveness which is behind increased commoditization." Says Kumar, "There is very little difference in terms of capabilities and performance in the hardware sector when brands are compared to assembled computers."

Moreover, no single company manufactures the entire system on its own. Each company produces one or two basic parts, which are assembled together



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and sold as a complete system. Several regions/companies have emerged as leaders for various products. Examples are Intel for microprocessor chips, Malaysian and Taiwanese companies for printed circuit boards and other electronic parts and so on. The commoditization of hardware has pushed down margins drastically. Most producers operate on wafer thin margins and rely on volumes to generate profits.

Opines Kumar, "Common sense is that when the margins are low the smartest thing is to concentrate on volumes. Therefore, the hardware industry in India is going to be a game of volumes especially in the PC segment. In the near future, possibility of consolidation in the industry seems imminent."

According to Agarwal, "Lack of technical awareness is a major reason behind the growing possibility of commoditization in the hardware sector." A parallel example is the telecom sector, he feels. In this sector, the pager industry is at the verge of dying a natural death as against the mobile industry, which is flourishing despite the fact that even in the developed countries like Japan and US, both co-exist. Till date, people in India failed to understand the importance of both the technologies. They just compare the messaging service with two-way communication service and the cost difference. Though it is true that a pager does not have the facilities of a mobile, it has its own utility, which the Indian market could not appreciate.

Lack of understanding about the usage is another reason for growing commoditization. In the fast growing segments like home users, Small Office Home Office (SOHO) etc., the users are not aware of the actual usage of the computers (utilization of features is as low as 12-14 percent). For example, in the SOHO segment, people are not concerned about the processing/manipulation of data but are just concerned with only reports. Says Agarwal, "I have seen many users getting satisfied with the printing of balance sheet (using Word Processor) than understanding the importance of generating the same using a Financial Accounting Software Package. At times, the computer system is used merely as a



"There is very little difference in terms of capabilities and performance in the hardware sector when brands are compared to assembled computers."

*Asbok Kumar, MD,
Lotus Strategic Consultants Ltd.,
Mumbai*

printing machine. Naturally, one neglects important attributes like computing power, math co-processor, bus-width, data size, etc." This lack of efficient utilization makes a computer more a commodity than a product.

Agarwal observes another significant reason for the commoditization of the hardware sector. It is the presence of non-serious players. In the gray market, many players are in the business of selling hardware just for the sake of doing some business. Some of them sell hardware in the summers and woolen clothes in the winters.

These are the players, who are mainly responsible for commoditization in the IT hardware sector. Asserts Agarwal, "Till date, IT hardware industry as a whole has not done much towards increasing the awareness about various issues related to hardware amongst the masses." Adds Agarwal, "As the

industry is passing through a 'Settlement Phase' globally, this is the right time to 'flash out' non-serious players by implementing a serious drive towards improving the awareness among users/buyers."

The other side of the coin is that commoditization prevents development of monopoly power within the industry. According to Dasgupta, "Commoditization helps in controlling monopoly, opens up an industry to competition and encourages development of new and improved techniques." Besides, commoditization in the hardware industry has been going on for over a decade.

The principal reason behind commoditization is the availability of

specifications in the public domain. In the software sector, this has had widespread acceptance in the form of public domain operating systems such as Linux and its variant flavors, and public domain application software such as StarOffice. In the hardware sector, commoditization in the last few years has helped in bring down monopolistic prices. It has also enabled smaller vendors that lack the research potential and infrastructure of established hardware manufacturers, to develop and improve their products without re-inventing the wheel or redefining an existing standard. "Most importantly," adds Dasgupta, "Commoditization has ensured that hardware vendors adhere to the same standards for manufacturing their products." An example of this is the USB (Universal Serial Bus) protocol that has become the industry standard for peripheral/external devices. Because of the standardization of USB, external devices from any manufacturer can interact with other devices or, a USB-capable computer of any make.

The software scenario

The road map to success in the case of software sector is a bit different from that of its counterpart. The traditionally accepted economic rule that scarcity creates value does not hold here. Says Dr. Mahesh Raisinghani, Program Director, E-business, University of Dallas, Graduate School of Management, US, "The difference today is that because everyone is linked, far more software products and services gain their value from widespread acceptance." Value rises exponentially with market share. Adds Raisinghani, "For products that help establish a platform or a standard, the network effect is even more pronounced." And therefore, the more

The commoditization of hardware has pushed down margins drastically. Most producers operate on wafer thin margins and rely on volumes to generate profits

plentiful they become, the more essential each individual unit is. And thus abundance creates value, not scarcity. Some software companies also tend to give up their products to establish market share, then sell linked services later on.

Prima facie, the question is whether the software services market is losing its product differentiation advantage that it once enjoyed and is a metamorphosis towards commoditization happening? Indeed, brand is more important in the software sector compared to hardware. Asserts Agarwal, "It is exactly like getting your dress stitched from an expert tailor and getting the same stitched from an inexperienced one." Occasionally in the second case, the risk of the procured software not meeting expectations is high. Proclaims Agarwal, "Commoditization of a service-oriented industry like IT is not possible and a small drift towards commoditization due to a slight change in the market scenario does not reflect that the entire industry is heading towards commoditization." Argues Trilokekar, "If functionalities, user friendliness and cost justification by way of improved productivity or savings can be effectively demonstrated, commoditization can be avoided to a great extent."

Despite all these factors, product differentiation in the software services industry is eroding rapidly. With increasing competition, products that once delivered unique advantages tend to face competition from me-too products that could be on offer at much lower costs. Says Datar, "This is applicable to services too where many vendors offer similar features with similar infrastructure and at similar price levels." The market place does seem to have reached a chaotic situation and commoditization seems to be evident. However, at the same time, it is in such

The non-price competitive differentiators in the IT marketplace

- Obtaining globally respected quality certifications to assure customers of quality of products and services.
- Building good service delivery networks either through own expansion or through tie-ups with other service providers that can meet the QoS (Quality of Service) standards expected by the customers.
- Investment in R&D to develop differentiable technology and processes to establish Intellectual Property rights.
- Developing reusable components and modularizing products and processes to ensure faster time-to-market and better standardization while also cutting costs of operation substantially.
- Refuse to get drawn into price-based comparisons and develop convincing competitive differentiators that can deliver enough additional value to the client to justify the higher cost.

*Ravindra Datar, Senior Analyst—IT Services,
Gartner India Research & Advisory Services*

chaotic times that buyers search for familiar names that they can trust and brand building can make a big difference. When everything else is the same, buyers are known to have decided in favor of brands that they are familiar with and have heard good things about. So, while the competition is reaching chaotic situation, brand building becomes all the more important. At the same time, customers are not ready to pay higher prices for brands. If branded products are available at the same price at which other vendors are selling, consumers would prefer brands. However, companies interested in building a brand image afresh has to think twice, as the mechanism calls for significant product differentiation to avoid commoditization. Product differentiation implies huge investments in R&D that will in turn be reflected in the price of the product. Higher prices, without significant difference in product quality and

characteristics, could again force the company to exit from the market.

The best example of this seems to be in the Internet services market. While America Online (AOL) has been the leading home Internet service provider over the last few years, more and more consumers are shifting to other service providers due to various reasons including price advantage, package deals covering telephony or cable television services, attractive promotional rebates, etc. Besides, the introduction of broadband/DSL communication services from home has created an improved product for the Internet services market. However, the broadband/DSL market with myriad providers is also not experiencing any major product differentiation. Customers are willing to choose from any provider that offers them the basic features, and perhaps an accompanying attractive package. In developing countries like India, price makes all the difference. For example, pirated versions of standard software products are available at such alarming cheap rates that the customer does not even bother about the after-sales service.

"The prediction is that markets are going to grow tougher and a few large Indian companies will emerge and maintain respectable growth rates" foresees Kumar. Today the talk is all about the big IT companies like Infosys, Wipro, Satyam, TCS etc., moving up the value chain and emerging as IT behemoths. Unfortunately, it is too simplistic and most stories don't have such happy endings. After the burst of the



"Commoditization will open up the market to more competition and last but not the least, help in establishing standards across the industry."

*Professor Pritbiraj Dasgupta,
Computer Science Department,
University of Nebraska, Omaha*

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TOWARDS COMMODITIZATION**The Brand Power**

Even a couple of decades ago the common perception was that building a good and solid brand bestows excellent returns for a long time. Big players dominated all the major industries: AT&T dominated telecom, Wal-Mart controlled the retailing business and IBM dominated the IT industry. The sole motive for any company was to be established in the consumers' minds. However, since the early nineties, the situation has begun to change. Every other week a new brand came up, thereby shaking the very pillars of the decade-old established ones. It is no longer that the biggest firms with established brand value could continue dominating the mind space of the consumers based on the past laurels. On the contrary, companies, which were capable of embracing the latest technology in the smartest possible way, started winning the race. Riding on technological innovation and expertise, it is possible for even a new entrant to create a strong brand identity. For instance, it took only \$300,000 for Pierre Omidyar to launch Amazon.com, and hardly any money when two Ph.D. aspirants started creating an Internet index and ended up launching Yahoo!, undoubtedly a strong brand.

However, the technological revolution has another side to it as well. The rapid advancement in technological processes has led to significant price falls. Today's rational consumer will hardly be loyal enough to buy a P&G product merely going by the brand without checking the price first. The growing feeling among market experts is that many business segments are fast moving towards commoditization. That is, when a company's products and services are remarkably similar to that of the competitors in features, marketing strategies and prices, thereby becoming less differentiated from the products of their competitors in the minds of consumers.

A study conducted by Copernicus, a marketing consulting and research firm, points out, "None of the 51 product and service categories studied are becoming more differentiated over time and 90 percent are declining in differentiation. The categories where least brand differentiation was noticed include IT hardware, bank services, credit cards and discount stores." The study made another important observation: In 28 out of 37 product categories, consumers viewed low prices to be more important than brand. Dr. Kevin J Clancy, Chairman and CEO of Copernicus notes that unless companies are able to develop value-added brands that set them apart from the competitors in their consumers' mind, profitability has to be sacrificed.

Products have a shorter shelf life compared to brands. Over a period of time, products may undergo various levels of metamorphosis or they may even vanish. However, brands serve to hold a value proposition in the minds of customers, irrespective of any particular product. A recent survey conducted by a group of consultants from McKinsey & Company suggested that successful companies spent 78 percent of their advertising budget on building company brand image, and just 22 percent on specific product features. However, the less successful companies did just the opposite.

For example, Microsoft has been spending heavily on brand promotion over the last few years to attach a distinguished identity and gain an image of a more "competent, user-friendly and reliable" company rather than popularizing the specific products or features. Similar is the story with Oracle that has replaced its regionalized advertisement strategy with a global ad agency to build a unified, worldwide brand. Companies like SAP and Baan have been successfully marketing "total business value proposition" of products together with the brands. Branding enables the company to build up a distinguished image. For example, Dell as a brand is known for value for money through its direct marketing process.

Source: Gartner Inc.

dotcom bubble, the global as well as the Indian IT companies are hard-hit. This is forcing them to implement more stringent cost-effective measures and market their products more aggressively. This may initially lead to consolidation in the industry, suffocating the second and third tier firms and gradually eliminating them. What eventually happens is that the large companies end up with offerings without significant differentiation. Price war emerges between the top 5-10 focused niche players that survived and the industry thus becomes commoditized. Though there is a reasonable top-line and bottom line growth, but the Return on Net Worth (RONW) suffers in the process.

Restoring brand equity

What can branded companies do to combat commoditization? One response is better service. Though unorganized players dominate currently, they fail to provide after-sales-services. The example of IBM is worth noting. The company's strong brand image has been built around its after-sales-service. It is also the availability and affordability of better application software along with the hardware and anytime-anywhere service network that can provide companies a competitive edge. Provision of superior quality at almost the same price as compared to that provided by the unorganized sector also makes a difference. Avers Agarwal, "Providing

the right product at the right price, with a long-term vision, is the only way to gain a competitive edge over the also-rans of the industry." It is the lack of vision and a myopic approach to business that will hinder the also-rans from surviving in the long run.

Another way of building brand equity is to cater to niche segments. This argument is especially valid in a market like India. Moreover, the software product development market in India, catering to Indian needs and requirements, is as yet vastly untapped. Opines Dasgupta, "In such a scenario, companies that have years of experience in a particular sector can use their expertise to develop software products

specific to that sector." For example, banking and insurance are two domains in the Indian financial sector that could benefit immensely from software product development. This sort of a sector-specific approach may enable the technology business to tap unexplored markets. Each domain has its own features, rules, and laws specific to India, and there are established Indian companies in these sectors that have been operating over several decades. Technology companies should try to exploit sectors in India that have not yet been computerized and could benefit immensely by automation of the activities.

"However, observing the present slowdown in the global software industry, it is very important for technology companies to distinguish themselves from 'also-running' lackadaisical competitors," warns Dasgupta. To do so technology companies should define their technology and product definitively, set feasible yet distinctive goals to deliver their solutions, and most importantly ensure that all their ideas and solutions are adequately patented. Once the initial product has been launched, technology companies should strive to discover niche markets and also identify and build customer base that remains dedicated to their product.

Combating commoditization

All said and done, companies like IBM and Microsoft have been able to stave off the threat of commoditization and survive as leaders. Can the business models of such companies be emulated elegantly? Definitely, it is an uphill task. Indian companies hardly have any brands at all and with increasing price wars there is very little left for them to emulate business models of global IT leaders. Asserts Datar, "It is important to ensure that a good PR and marketing communications exercise is in place to ensure that a critical mass of users is built quickly to catch the interest of other software developers to develop their products and services around the product." In the standards game, the product that has more users is the one that generally becomes the industry

In the standards game, the product that has more users is the one that generally becomes the industry standard



"Brand advantage cannot be sustained unless a firm understands what capabilities and competencies are needed to build/acquire/leverage to create rich experiences."

*Dr. Mahesh Raisinghani,
Program Director, E-business,
University of Dallas, GSM, USA*

standard. While the quality of the product (with zero bugs and low support requirement) is the basic necessity, intuitive design to take care of most of the user's requirements, ease of use, adherence to existing global standards of products related to it are other product related necessities in building a strong market position. On the commercial side, it is important to achieve rapid market penetration through a good distribution network for the product and its allied services. This could be achieved through tie-ups with major IT services vendors and IT consultants while also establishing a strong network of product distributors in target markets. It is also important to give enough marketing communications support to the product to ensure higher brand recall and therefore, higher number of trial users.

Software companies should try to identify and build their own niche products." Says Raisinghani, "Brand advantage cannot be sustained unless a firm understands what capabilities and competencies are needed to build/acquire/leverage to create rich experiences." How quickly, efficiently, and effectively can the firm execute its strategy is equally important.

Dell's direct-to-customer and build-to-order business model is a good example to understand this phenomenon. The company's model helps hold down inventories of components and finished computers, which in turn controls costs. Companies like Dell and Microsoft, which are able to successfully leverage on their brand name, prove that brand advantage is not eroding. However, the executives of the

companies able to restore their brand equity today must be vigilant and continue to prioritize in a dynamic, constant changing environment to carry forward the advantage to the future.

Back home, India's software industry has primarily followed the outsourcing model. While the industry has grown and gained fame and fortune along the way, the reputation of software companies like Oracle and Microsoft, which develop and sell products, has secluded India's software players from global competition.

Avers Kumar, "To develop strong brand equity, companies should have the unique capability of empathizing with the customer's needs, and assisting them in both development and marketing of products and solutions appropriately." He adds, "In order to acquire global reach, products should focus on just one industry, unlike many players, who attempt to cater to all industries." They should also be careful of not producing shrink-wrapped products, but mission-critical ones with end-to-end integration. Consideration of the various demands of the end-users will enable them to create higher values for their products and services. World-class organizations realize the importance that quality plays in their bid to move up the value chain. Indian companies too need to realize the same. The quality initiative will pay rich dividends increasing productivity and efficient time management. Over years this will lead to reduction in the number of defects. The constant focus on quality, productivity and efficiency will manifest itself in the form of originality in the long run. These aspects will enable companies to smoothly sail in turbulent waters. After all, it is nothing but gaining the confidence of the consumers in the long run.

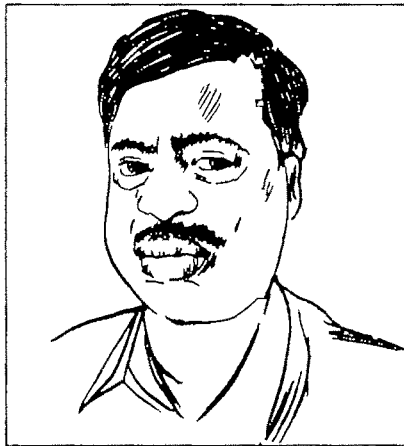
TOWARDS COMMODITIZATION

India: Strategic focus

Against the backdrop of the burst of the dotcom bubble and increased commoditization that is sweeping the hardware as well as the software solutions sectors, a question that ponders all minds is where should Indian companies focus and specialize in the future?

While Indian IT companies have the required potential to plunge into both the software as well as the hardware sectors, there are a few problems. Says Trilokekar, "India has not gone into product market mainly because of taxation at the input level for material that has to be imported." Again, cost of production has made selling in global markets virtually impossible as economies of scale were not achievable. However, recently, there have been changes in policies, which may enable the availability of manufacturing expertise compared to many other countries and if infrastructure is improved India can be globally competitive. Undoubtedly, India has a large skilled and semi-skilled cheap supply of workforce. Asserts Bhattacharyya, "The Indian workforce is very technology savvy, skilful and can easily adapt after requirement-specific training is provided. So India should take this risk of plunging into the product market in a phased manner - small components and cards first, then full systems and peripherals." On similar lines Jaunhunwa comments, "The product market is difficult. It takes a longer time and a larger investment. But in the end, the returns of products are far higher. Of course, one must keep in mind whom the products are meant for, associated quality requirements and keeping the affordability issue in mind."

However, product business is more capital intensive compared to software services business. And therefore it is riskier for a country like India to blindly plunge into it. This is something that Indian companies understand well. And this aspect has enabled India to gradually evolve as a IT services hub. While explaining the element of riskiness involved in product business, Kumar argues, "In case the products fail to gain acceptability, it adversely affects the performance and prospects." However, companies like Wipro, HCL and Hughes



"The experience from other industries has shown that the IT industry needs to become more efficient in bringing the cost down to expand the market."

*Asbok Jaunhunwala,
Head, TeNeT,
IIT, Madras*

India has vast human, industrial and technological resources but lacks the financial muscle required for product development

that are involved in R&D work equally as IT services, and are also into product business. Hughes' contract with Nokia, which entails low billing rates for the initial services contract and further payment on the success of the product, is an example of risk sharing. Product development no doubt increases R&D and marketing costs but the returns as well as the future growth is immense in this field. To come to the point, India has vast human, industrial and technological resources but lacks the financial muscle required for product development. That

explains why Indian IT players are better placed on services rather than products. Says Agarwal, "For Indian IT industry it is advisable to remain in service sector due to strengths like manpower resources, low cost of manpower, large pool of English speaking people, etc. It is the best choice to remain in industry where the intellect matters. In the software product segments, besides intellect, what matters more is packages, publicity, etc. which requires very heavy investment."

Moreover, the social, political and economic structure of India is considerably different from that of the West. Therefore, in India there are still a large number of service sectors, and applications within those sectors that need to be studied, analyzed and solved, preferably with the aid of software products. Avers Dasgupta, "The software product market in India is not only under-utilized but un-utilized as well. Venturing into the software product market is indeed risky." But entrepreneurs need to venture into it, at least in a small way to

begin with, understand the responses and needs of the software product market and then serve the needs of the market gradually. This is because the industry has to look for greener pastures in the long run. The software services market is finite and with time and more number of players, it will inevitably get saturated. Therefore, Indian software manufacturers must venture into the software product market.

Complacency is something that can possibly wipe out all that the industry has gained over painstaking years of effort. The industry and vendors need to keep a constant lookout for emerging threats as well as opportunities. It is not good enough to be on the right track. Aggressive competition will knock you down if you just sit there resting on past laurels and are not moving fast enough in the right direction.

According to Datar, "It is important for Indian IT Services vendors to move up the value chain and apply all that they have learnt through years of experience in providing services, to develop modular or shrink-wrapped solutions." It is important to apply all the knowledge gained through service business to developing standard solutions that can meet the requirements of most of the target users and are customizable enough to meet the requirements of all the target customers with a little adjustment. Establishing Intellectual Property Rights in process development wherein companies can apply their service delivery knowledge to developing processes is also an important strategy to victory. This can reduce time and cost requirements in providing a solution to the customer.

Adds Datar, "Productization of services is the way forward for Indian IT services providers so that they can rise

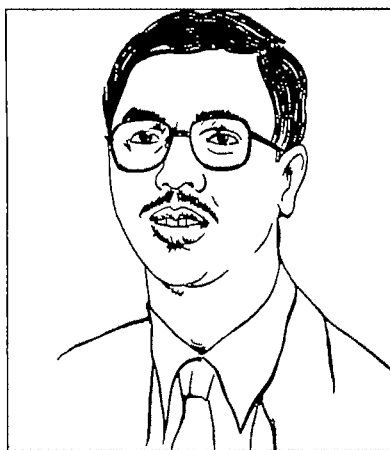
above the pricing game and focus on delivering high value solutions to their clients." The benefit of such a product strategy is apparent from the fact that a company spends a lot of money in delivering service every time it signs a service contract, but in case of a product, the money spent on development is spent only once but the product is sold many times over without much additional expenses. It is also important for Indian IT services vendors to move from the low-cost approach to selling their services to the high value-added approach wherein the margins can be higher while also generating more business for their downstream volumes business.

Lessons from others

A look at the way many old economy companies and industries have moved in various times in their product cycles tells that whenever there is a clean up in an industry after a period of high growth (as it is happening in the Indian IT industry), a new set of leaders emerge with new ways of doing business that fundamentally change the rules of competition. In the automobiles industry, the Japanese car companies emerged from the oil shock years. In the computer industry, DEC emerged from the ashes of the mainframe business and was soon replaced by Compaq when PCs gained prominence. Look at any industry and the story repeats itself with very rare exceptions like Intel. Thus purely from a historical point of view, Indian IT firms have the odds heavily stacked against them.

Says Kumar, "From televisions to PCs to broadcasting, this has happened and there is no sane reason why this should not happen in the IT services business." Indian IT companies have to do something extraordinary to demonstrate that their competitive advantage is enduring. To be fair, Indian IT companies have done an excellent job in adopting to change. "Unless Indian IT companies reinvent themselves, in another five years they will become the also-rans just like another average industry. That will mean an average P/E of 10," asserts Kumar.

"The IT industry is distinct from the telecom and airlines, which mainly constitute services and are devoid of any



"Productization of services is the way forward for Indian IT services providers so that they can rise above the pricing game and focus on delivering high value solutions to their clients."

*Ravindra Datar,
Senior Analyst-IT Services, Gartner India,
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tangible products. On the other hand, the automobile and electronics industries are not yet fully commoditized," says Dasgupta. So, according to him, there are hardly any lessons that can be learnt from the experience of other industries that also experienced commoditization and their turnaround story. In the IT industry, every manufacturer should try to identify its niche domain and develop products that build up from a common base, but

In the IT industry, every manufacturer should try to identify its niche domain and develop products that build up from a common base, but excel in their niche domain

excel in their niche domain. This ensures that although the products manufactured fall under the same broad category, they cater to the individual niche markets.

Jhunjhunwala points out, "The experience from other industries has shown that the IT industry needs to become more efficient in bringing the cost down to expand the market." It is important to look beyond price and look for ways to deliver added value through innovation to an extent that price becomes a non-issue. Says Datar, "While the terms of service might be very similar in a commoditized market, it is the quality of people that deliver the service that makes a big difference." Even in a commoditized market one sees that some brands are preferred more over others due to factors other than price. For example, in the airlines industry, hardly anybody would mind paying a few extra dollars if a certain airline company offers better quality service than others and its staff treats the passengers better, despite the terms of service and facilities provided by most airline companies are very much the same. Shikhar Ghosh in his paper published by Harvard Business Review,

titled, "Making Business Sense of the Internet," points out, "Ultimately the risk of the Internet commerce for established businesses is not from digital tornadoes but from digital termites." So, it is equally important to be careful about the micro-aspects of strategic management rather than always concentrating on the macro-aspects.

Survival of the fittest

Commoditization makes the market more competitive, combating the evils of monopoly power. It assures survival of the fittest. Those companies which will be able to continuously integrate the benefits of technological progress, yet maintain an affordable price will beat the market. The market environment in the West is quite different from that in countries like India. Indeed selling a product be it software or hardware is more difficult in India than in the West. In the West, quality and features drive the show. However, in India it is not only quality and features but also price considerations that rules the roost. Though the market thrives for branded products, when prices of branded products are significantly different from those of the also-rans, it is the commodity that wins the game over the product. However, it is important for the Indian IT industry to act very patiently and with a sense of maturity and urgency, which must not be derived by the temporary sentiments. The Indian IT market is still un-touched to a large extent. In the words of Agarwal, "There are no stoppings, only a long clear way to drive." ■

Debasis Mallik, Team Analyst

Reference # 1-2002-05-03

COUNTRY SCAN

France

Alliance Francaise!

France, one of the world's most developed countries (with a per capita income of about \$22,000) has also emerged as one of the most eccentric. In the age of liberalization, privatization and globalization, the French still believe in strong governmental controls.

Due to excessive state intervention, the French economy has not quite performed to its full potential. During the 1990s, the Government did make some progress in privatization and reduction of budget deficits. Taxes, however, still remain the highest among the G-7 industrial countries. Regulation of goods and labor markets is quite high for a developed country. Moreover, rigidities still plague the labor market. Experts wonder whether the estimated structural rate of unemployment of 3.5 percent can be reduced. Efforts to privatize continue, but the Government still controls major firms in several sectors. In addition, the French concept of a "golden share" enables the Government to block strategic moves made by firms in which it holds a minority interest.

Money matters

Like many other industrialized countries, the French economy is dominated by services. The services sector accounts for 72 percent of the GDP. Agriculture and agro-food industries account for six percent of the total value added in the French economy. Manufacturing accounts for 16 percent of GDP, construction for four percent and energy generation for three percent. Many of the services such as health care, education, telecommunications and transport are in public sector.

During the last few years, France has witnessed a distinct improvement in many macroeconomic indicators. The budget deficit had increased sharply in the early 1990s, but the situation has been improving since 1994. This improvement is the result of curbs on spending by Central Government, local authorities and the social security system. For a long

time, inflation was high in France but it has now been reined in. From 14 percent per year in the early 1980s, it was brought below three percent in 1991. The downward trend has continued in recent times with 1.5 percent for 1996, 1.3 percent for 1997 and 1.3 percent in 1999. As a result, France, after meeting the criteria set by the Treaty of Maastricht, has entered the Eurozone.

Most Frenchmen are happy with the strong state. It played a major role in the 30 years of spectacular economic growth after the Second World War, which rapidly industrialized a mostly rural economy. It also made France the world's fourth-largest industrial power after America, Japan and Germany.

The French have all along felt that their model is superior to the US, due to its emphasis on equality and community. The French dislike for the American style of management intensified in the 1950s under the twin influences of the French Communist Party and General Charles de Gaulle. De Gaulle once said that France would show the world how to "build an industrial civilization which is not derived from the American model and in

which man will serve as an end, not a means."

But despite the rhetoric, the French businessmen have been quietly and slowly changing with the times. Various sectors of the economy have been liberalized. Electricity, telecommunications and gas markets have been opened to competition. One-time icons of the French State such as Air France, Aerospatiale and France Telecom have been partially privatized. Foreign investors hold nearly half the shares in many formerly state-owned firms such as

Societe Generale (a bank) and Elf (an oil giant).

Labor wealth

One of France's major strengths is high labor productivity. Measured by output per hour worked, labor productivity in France is higher than America. However, the main reason for this phenomenon is that the companies in France employ fewer people and prefer to grow by investing in machines. High social-security charges, redundancy pay and rigid rules about hiring and firing make employers think twice before recruiting more workers.

The enforced introduction of a 35-hour week in 2000 is a good example of state interventionism to regulate work practices. The law, however, has had unintended consequences. Employers are using the prospect of a shorter week to extract various concessions from the unions: Wage moderation, weekend work and late-night shifts. Many jobs in the private sector are now in the form of short-term contracts.

A major headache for France is its pension system. The young generation effectively supports the older generation's pensions. The dependency ratio, people over 60 as a proportion of those aged 20-60, is roughly one to three currently.

Health care is another area of concern. The French spend about 10 percent of their GDP on health care, more than any other country in the EU. Per capita consumption of tranquilizers, sleeping pills and anti-depressants is probably the highest in the developed world. The Government has tried to curb costs in various ways, but much more has to be done.

Tax rates in France are well above the EU average. The standard rate of corporate tax is 33.3 percent, while that of value added tax is 19.6 percent. The peak income tax rate is 52.75 percent.

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Trade across borders

By becoming more open to the rest of the world since 1945 and casting aside its traditional protectionist attitudes, France has emerged as one of the most important players in the global economy. In 2000, France exported goods worth \$295.5 bn and imported goods valued at \$294.4 bn. It now accounts for six percent of world trade, second only to the USA in services and agricultural exports and fourth in industrial products. The country's exports account for 21 percent of its GDP.

France's five largest customers are its closest European neighbors: Germany, United Kingdom, Italy, Belgium-Luxembourg and Spain. These countries are also France's largest suppliers with the exception of Spain. Germany has long been France's leading trading partner, currently accounting for 16.3 percent of total French foreign trade, ahead of Italy (9.6 percent) and the UK (9.2 percent). In 1996 and 1997, France's chronic trade deficit with Germany was reversed. Outside the EU, France has three main trading partners: The USA and Japan, with both of which it has a trade deficit and Switzerland, with which it has a large trade surplus.

Foreign investments

French government officials see foreign investment as a way to create jobs and stimulate growth. Investment regulations are simple. A range of financial incentives is provided to foreign investors. The investment promotion agency, DATAR, provides assistance to potential investors. The formal French investment regime is among the world's least restrictive. There is no generalized screening of foreign investments. But acquisitions are subject to official reviews. Also, in some sectors, policies tend to favor investors from other EU countries only.

France has attracted many coveted IT, communications and automotive investments in recent times. The country's main attractions are its skilled labor force, central location in Europe and good infrastructure. IT overtook automobiles as the top FDI sector in France in 1998. In May 1999, the French Government announced an annual fund to encourage R&D in five priority areas—life sciences, IT, human and social sciences, energy and transport and earth and environmental sciences.

In November 1999, Sun Microsystems announced it would expand its European R&D center in Grenoble. Sun preferred Grenoble to other sites in Europe because

Important Macroeconomic Indicators				
	1997	1998	1999	2000
GDP per head (USD)	24,033	24,640	24,306	21,700
GDP (% real change p.a.)	1.89	3.33	3.18	3.19
Government consumption (% of GDP)	24.21	23.54	23.64	23.47
Budget balance (% of GDP)	-3.10	-2.80	-1.70	-1.30
Consumer prices (% change p.a.; av)	1.22	0.59	0.57	1.69
Public debt (% of GDP)	64.70	65.19	64.94	63.30
Labor costs per hour (USD)	17.99	18.28	17.98	16.23
Recorded unemployment (%)	12.48	11.86	11.22	9.72
Current-account balance/GDP	2.69	2.61	2.55	1.80
Foreign-exchange reserves (bn\$)	30	44	39	37
Source: Economist Intelligence Unit				

of its excellent R&D infrastructure including local universities and engineering schools. In the same year, another American company, Lucent Technologies announced that it would locate a new European R&D center in France for development of third generation mobile phones.

But the French are still somewhat paranoid about giving up control of their businesses to foreigners. There has been stiff labor opposition to acquisitions of French businesses by the US firms. In other cases, French firms have shown a distinct preference for working with French and European firms, rather than American firms. Lack of transparency in the privatization process has aggravated suspicions about the equal treatment of foreign investors in public companies.

Many foreign investors cite excessive labor regulation and high income and payroll taxes as the greatest disincentive to investing in France. A specific tax burden faced by US investors is the treatment by French authorities of two social security taxes, as income taxes rather than as social security contributions. Therefore, companies and employees effectively contribute to the financing of two social security systems. The need to compensate foreign workers for the extra tax burdens of people working abroad has considerably increased the cost of employing highly skilled expatriate workers.

Infrastructure

France has one of the densest and most efficient transportation networks in the world. Roads carry 60 percent of domestic freight, compared to 40 percent in 1970. Nearly 90 percent of travel is made by road, mainly by cars, although use of public transport is rising sharply, especially for tourism. With over 965,000 km of roads, the French network is the

biggest in Europe. International links have increased with the construction of the Paris-Lille-Brussels, Macon-Genève and Perpignan-Barcelona motorways and the Mont-Blanc (1965), Fréjus (1984) and Puymorens (1994) road tunnels. The three main entry points for airfreight are the Orly and Charles de Gaulle airports in Paris and Saint-Exupéry airport in Lyon. France has 12 major seaports, many of which are equipped for container ships. There is also an extensive river-transport system. The communications infrastructure is also advanced and telephone lines cover the whole country. There is easy access to the Internet. The French "Minitel", a telephone-based computer network is widespread and provides many consumer services. High-speed Internet access though limited is expanding rapidly. The Government is also trying to promote widespread use of information technology.

Outlook

France stands at the crossroads today. It is still a world leader in many industries. With its sophisticated infrastructure and highly skilled labor, France is a player to reckon with in the global economy. Many French companies have been aggressive globalizers. Carrefour, the retail chain and Renault, the automobile company are good examples. Renault, which took a stake in Nissan, has done a remarkable job of reviving the ailing Japanese company's fortunes. But many of France's policies that revolve around active state intervention are proving to be increasingly burdensome and expensive. ■

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Reference # 1-2002-05-04

SPOTLIGHT

Socially Responsible Investing

A conscience call

Most investors have a concern for social and environmental causes; few of them try to work towards them. Socially responsible investors are those few who invest for a cause and try to make the corporate world more responsible to the society at large. And the good news is that their numbers are growing.

There is a growing awareness among investors about social and environmental issues. Investors are increasingly voicing their concerns on women empowerment, environmental protection, workplace ethics and other such issues. Enron and several other corporate fiascos in recent times have brought corporates under the scrutiny of ethically and socially concerned investors. These new breed of investors scout for good corporate behavior and as their number and clout swells, they could have a strong influence on companies making them more responsible toward society. Social investors could be individuals, businesses, universities, hospitals, foundations, pension funds, religious institutions, and other non-profit organizations. They consciously put their money to achieve specific financial goals while working for the betterment of the society.

It comes as no surprise then that out of every eight dollars under professional management, one is invested for a social or environmental cause. Though socially responsible investments are a relatively small part of total investments, they are increasingly becoming more widely held and potent. Known variously as social investing, socially responsible investing, socially aware investing, ethical investing, mission-based investing, and natural investing, the concept hopes to achieve a social as well as a financial return.

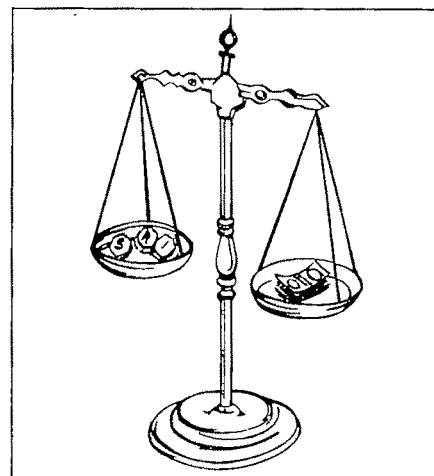
SRI: Over the years

The roots of SRI can be traced back to biblical times when Jewish laws directed investments as per ethical values. Quakers practiced socially responsible investing in North America, as early as the 16th century, based on their beliefs in human equality and non-violence. However, the current movement really began during the Vietnam War when most investors were against their money

going to support the war. After Vietnam, the apartheid in South Africa reinforced the power of SRI. In South Africa, investors campaigned to eliminate the institutionalized racial discrimination in the country. Incidents like the Exxon Valdez oil spill or the Bhopal Union Carbide plant disaster, along with constant alerts about toxic waste, global warming, ozone depletion and other environmental threats, continue to figure prominently in the minds of social investors. As socially responsible portfolios move beyond selecting companies that strive to halt their negative environmental and social impacts to choosing companies that are proactive in improving their social and environmental performance, corporates may prioritize social activity. Already, social issues such as employee-employer relationship, human rights in overseas factories, and socially destructive products such as tobacco, have had companies gearing up.

According to Social Investment Forum (SIF) report, assets in professionally managed, socially screened investment portfolios rose by 36 percent from 1999 to 2001. Social investments now account for about 12 percent of the estimated \$19.9 tn under professional management in the US, according to the SIF report. The number of socially responsible mutual funds using one or more social criteria has grown from 168 to 230 funds over the past two years. These include equity, balanced, international, bond, index, and money market funds. Hundreds of institutions and mutual fund companies have used the power of their ownership positions in publicly held companies to sponsor shareholder resolutions or vote their proxies on corporate social responsibility issues.

SRI's growth and popularity is not restricted to US; it has been growing



globally. In Canada, the SRI market was worth US\$ 1.31 bn in terms of assets under management, as of October 2000. In the same year, in Australia, the SRI market was worth US\$ 367 mn. Today, due to consumer demand, active management and government regulations, there are about 220 SRI funds in Europe. In the UK, the value of funds actively implementing an SRI policy, including retail funds, was about £120 bn in October 2001, up from £52 bn in December 1999. In the UK, the current number of retail funds screened using SRI criteria is 60. Reflecting a similar trend, Germany SRI funds have trebled from €500 mn to €1.5 bn in 2000 (see Table 1).

Three strategies of SRI

Socially responsible investing integrates three strategies to achieve its objective. The first of them is screening, or choosing securities based on social or environmental criteria. Screening usually involves excluding certain companies for products or practices that are considered negative, called avoidance or "negative screening." The oldest social screen around is the sin screen. Universities and churches have used this screen for over 100 years to avoid companies that are into

tobacco, liquor or gambling investments. Then there is "positive screening" that involves selecting companies based on their positive contributions to society or the environment.

The second strategy is shareholder activism. Ownership rights and responsibilities come to shareholders when they invest in companies. A growing number of social investors are using their roles as corporate owners to advocate their issues of concern through efforts such as talking to companies, filing or co-filing, and voting proxy resolutions. Proxy resolutions on social issues are generally aimed at influencing corporate behavior toward a more responsible level of corporate citizenship, driving management into acting toward the well-being of all the company's stakeholders, and improving financial performance alongside.

Socially educated and concerned investors can substantially influence corporate behavior. For example, shareholder pressure played a significant role in convincing General Electric to support stronger efficiency standards for washing machines, which led to major improvements across the industry. Mitsubishi's shareholders were responsible for shelving plans for a salt factory near Baja, California's San Ignacio Lagoon, to protect this gray whale calving site. Similarly, Coca-Cola and PepsiCo were asked to increase the amount of recycled plastic used to make new plastic beverage bottles. Last year, Coca-Cola and Pepsi shareholders, through a resolution, asked the companies to meet the 25 percent recycling goal they agreed to nearly a decade ago, and to set an 80 percent container recovery goal by 2005.

The last of the strategies is termed community investing, which is the most

What is SRI?

Socially Responsible Investing (SRI) is an investment process that takes into consideration social and environmental consequences of investments, both positive and negative, within the financial analysis framework. In other words, SRI couples rigorous quantitative analysis with scrupulous qualitative scrutiny. It is a process of identifying and investing in companies that live up to certain basic criteria like open and transparent business practices that are based on ethical values and respect for employees, communities and the environment, collectively referred to as Corporate Social Responsibility (CSR). CSR contributes to long-term business success and shareholder value. Ethically and morally aware consumers and investors are integrating CSR concerns into their purchasing and investment decisions. Global corporations that have developed Corporate Governance Codes or endorsed environmental and social codes appreciate investors' appeals for good governance and socially responsible behavior.

direct route for investors to gain "social" returns. The community investments occur mostly at the local level and in many cases, the communities' development far outweighs any diminished financial returns. Therefore, community investing is one of the most satisfying and promising form of investing and is popular among socially responsible investors and may also drive the future growth of SRI.

Community investments provide low interest rate loans to people in low-income communities, thereby creating jobs and helping local organizations set up small businesses, affordable housing, and community services such as childcare. In addition to supplying badly needed capital in under-served neighborhoods, community investment groups provide important services, such as education, mentoring, and technical support. They also build relationships between families, non-profit organizations, small businesses, and conventional financial institutions and markets.

Over the years, community investing has grown rapidly. Its geographic reach has expanded and the range of its beneficiaries has multiplied. Community investing has helped backward Indian women launch very small businesses to feed their families. It has also enabled small farmers in draught-stricken areas of Nicaragua to obtain financing for their own commercial coffee co-operatives, and made it possible for black families barred from

credit under apartheid to borrow what they needed to build viable communities in the new South Africa.

Mutual funds and SRI

SRI is about individual ethical values. It is based on the belief that no company is perfect. A company that manufactures weapons or tobacco might be a great advocate of employee empowerment. Another company that produces life-saving drugs or fertilizers, which benefit the local economy, might also produce toxic wastes in the process. Socially and environmentally screened mutual funds, thus, cannot be viewed in black and white. There is a whole spectrum of colors representing various strengths and weaknesses of companies based on the fund's qualitative criteria.

Social investment requires investment managers to overlay a qualitative analysis of corporate policies, practices, and impacts onto the traditional quantitative analysis of profit potential. As the process of screening requires extensive research into company policies and practices, most socially-oriented investors rely on mutual funds to manage their screened investments. Socially responsible mutual funds are screened to match any investor's values. While mutual fund companies are better equipped to screen companies for social investing, a major portion of their information is sourced from corporate disclosures. Sometimes investors may be crippled by the lack of information or may be misled by wrong disclosures.

United Kingdom is a perfect example of a socially investor-friendly nation. Since July 2000, United Kingdom pension plans have been required to declare whether and how they integrate social and environmental factors into their investment decisions. While pension

Table 1: Overview of Ethical Mutual Fund Market as of 30/12/2000

Country	# of Ethical mutual funds	Ethical assets under management in million USD	As % of total mutual fund assets (%)
Belgium*	26	602	0.80
France*	14	371	0.01
Germany	22	1,317	0.04
Italy*	5	2,077	0.45
Sweden*	42	1,190	1.46
Switzerland*	22	1,011	1.12
The Netherlands	11	1,309	1.20
United Kingdom	55	6,390	1.35
United States	230	153,000	2.26

* Size at 31/12/99

Sources: Avenir, VBDO, EIRIS, Socialinvest, Arèse, IMUG

SOCIALLY RESPONSIBLE INVESTING

Women Power

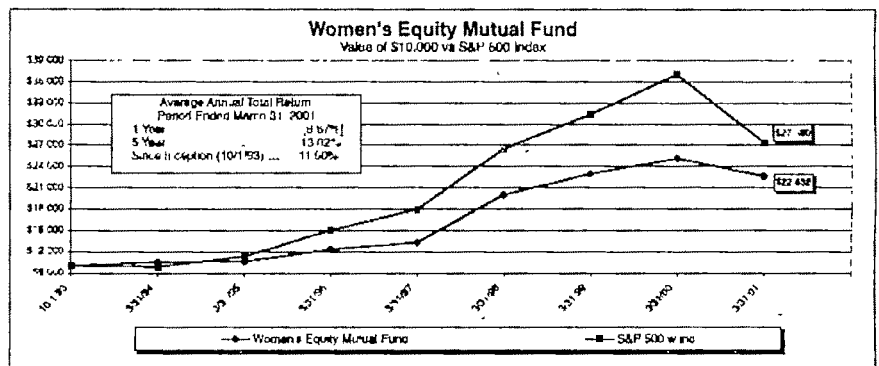
Women Equity Mutual Fund encourages long-term capital appreciation for its investors by investing in corporations that meet both financial standards and the criteria for the advancement of women in the workplace. Its major investors are women and the fund is increasingly gaining popularity with men also. The fund primarily invests in companies that satisfy certain social responsibility criteria and that are proactive toward women's social and economic equality. At least 65 percent of the fund's total assets are invested in equity securities of companies who satisfy the fund's criteria.

It targets investors who pursue a long-term goal such as retirement, people who are willing to take high short-term risks for long-term benefits. The fund seeks out companies that are well managed, growth-oriented, and financially sound. After analyzing macroeconomic indices (inflation, interest rates, corporate profits, market trends etc.), the fund examines the long-term earning growth potential of promising companies, selecting for inclusion in the portfolio those companies that have the strongest policies with regards to hiring, supporting and promoting women. At the same time it avoids companies that have a record of Equal Employment Opportunity Act violations, sell or promote products that adversely affect women or are unwilling to value women issues.

How it influences corporate behavior

They talk with managers of companies that have uneven track records with regard to women about how they can strengthen specific programs and policies. They actively work with organizations seeking to increase leadership opportunities for women employees. They educate individuals and corporations by publicizing the good records of companies that deserve support and recognition. When companies are unresponsive to the suggestions on how they can improve their policies regarding women, they consider initiating shareholder actions, e.g., voting on proxy statements before annual meetings or sponsoring shareholder resolutions.

The performance of WEMF as against S&P index reflects its popularity, acceptance and growth.



Source: www.women's-equity.com

plans are free to declare that they do not and have no intention of doing so, this new regulation has resulted in a new resolve by many pension funds to engage corporations in dialog on social and environmental issues. Similar new regulations are in place in Canada and Germany, and a legislation along these lines is working its way through France and Australia. Going ahead in October 2001, the Association of British Insurers in UK, whose members account for more than 25 percent of all London stock market investments, called on companies to establish formal systems to identify risks and opportunities arising from ethical and environmental issues, to disclose which of these issues are significant for business, and to describe the policies and management systems they have in place to address these risks.

The journey ahead

While there are funds such as Women Equity Mutual Funds (WEMF) that encourage women development (see

box: Women Power), there are also myriad religious mutual funds and indexes with the tenets of a specific faith at the forefront of the decision-making process developed by religious-minded organizations. Religious funds have duplicated over the years and investors can choose from a growing number of religious investment options which include new offerings from Carlisle Social Investments (Catholic), Dow Jones (Islamic), MMA Praxis Mutual Funds (Anabaptist) and others.

Reid Cooper, a corporate social responsibility researcher at York University, Toronto, Ontario, says, "SRI is democratic in mindset, it makes sure that investors' personal ethical values are reflected in the financial investments they make. But there are also more immediate reasons for not completely excluding religious groups. There would be no SRI without religious groups, since they played a pioneering role. That's one reason

why, in the US at least, SRI funds almost still exclude alcohol. For many people morality is an outgrowth of religion. It is a matter of opinion."

Then again, such narrowing of the focus of SRI in today's global economy may go against the true objective of social investing. These kinds of against-the-tide funds may artificially buoy up the demand and compromise heavily on the social objectives. Socially responsible investing is increasingly a global phenomenon, every step forward in one country helps validate and strengthen the argument and basis for SRI in another nation. In the same breath, every wrong step may have wide-ranging repercussions worldwide. The proponents of SRI have to proceed with extreme caution while making a case for SRI. ■

CSV Ratna, Team Analyst

Reference # 1-2002-05-05

Management Consultancy

Time for few new ideas

The history of consultancy business is replete with examples of failures outscoring winners. AT&T's continuing troubles and more recently the disgraceful collapse of Enron, all tell a sorry tale about the profession. Will the idea machines generate a few fresh, and winning ideas?

"A consultant is a person who takes your money and annoys your employees while tirelessly searching for the best ways to extend the consulting contract"

—Scott Adams, Author, Dilbert Principle

AT&T's future is bleak, and with several other states in the US also expected to push for further deregulation of the telecom market, "long distance will be a memory" for this yesteryears' monolith, reported *Washington Post*, on January 16, this year. Taking a further dig at the company, the daily commented that although the communication major may have more than 100 years of experience catering to the needs of telephone consumers, it has sought help of Accenture, a consultancy firm, to advise it on reducing its operational costs. And the advice would come at a princely sum of \$2.6 bn.

This is not for the first time that the US telecom giant is flirting with consultants. In the 1990s, the company used to be a management consultant's dream client, doling out about billion dollars during that period on an army of consultants. Between 1989 and 1984 alone, the company spent over \$500 mn as consultancy fees. More than a thousand firms, right from big names like McKinsey to smaller fry like Delta, vied fiercely to grab this prized catch.

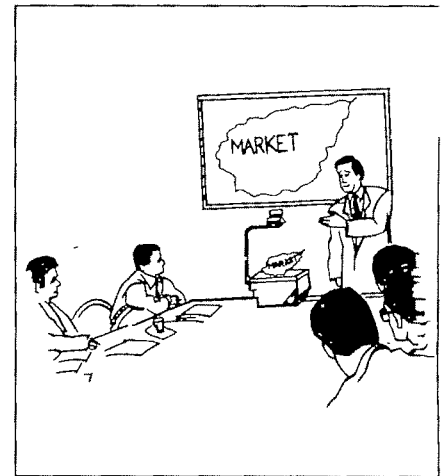
Courtesy their advice, the company took several ill-fated decisions like the overpriced acquisition of NCR, a computer maker, which led to bitter job cuts and unrest among the workforce. Critics played the company for committing acts like renaming managers as coaches, tearing down office doors, and encouraging employees to wear T-shirts bearing the message "Putting the

moose on the table", in the name of damage control measures. Based on the consultant's advice, the company spent \$20 bn on buying new businesses and incurred \$19 bn as restructuring costs, though it continued to lose market share. Disenchanted by the disastrous results of the company, the first thing the new CEO John Walter did after taking charge in November 1995, was to show the door to several of those consultants and asked his people to start thinking for themselves. Thereafter the company's results started showing some improvement.

AT&T's stumbling performance has always been a big excuse for cynics to take a dig at consultants. However, they now have a host of such opportunities, thanks to the Enron saga (The company's post-mortem report suggests how several of its top executives, including CEO Jeff Skilling, who came from the consultancy industry

failed to manage the affairs of the energy-trading firm), to hit out at this self-proclaimed breed of idea machines, not to say money machines too. In fact, history is replete with such examples where failures outscore winners (James O' Shea and Charles Medigan, the celebrated authors of the book *Dangerous Company* should know better). This book shows how big companies got into never-ending troubles after seeking consultants' advice. Big failures like Sears, AT&T, and People Express suggest that the idea machines have churned out more trash than any novel but workable concepts.

The big question then is, why do companies go in for management consultancy and has the moment of reckoning come for the profession?



Problems galore

Management consulting has emerged as one of the most successful professions in the world, generating revenues of more than \$100 bn a year, thanks to the fattening fee packet. In most cases, these consultants receive higher fees than what the chief executive of the company they advise earns. But as the flurry of corporate disasters in recent times suggest, their fat pay packet hardly justifies their performance. Examples abound on the laxity on the part of consultants.

CSC Index, the originator of the idea of "Business Re-engineering", was alleged to have rigged the sales of books written by its consultants in order to get them into a key list of best sellers. Two consultants from the firm came up with the idea of a book, based on Michael Porter's "cost or quality" theory. Unfortunately, the firm's publicity machine took marketing of the book to the extremes and started buying up large numbers of their own book to push it up the *New York Times* bestseller list. The subsequent scandal did great damage to the firm's reputation.

AT&T's stumbling performance has always been a big excuse for cynics to take a dig at consultants. However, they now have a host of such opportunities, thanks to the Enron saga

MANAGEMENT CONSULTANCY

Top 50 Global Management Consultancy Firms			
Main Office		Main Office	
1. Andersen Consulting	Chicago, IL	26. Arthur D. Little	Cambridge, MA
2. PricewaterhouseCoopers	New York, NY	27. Bain & Company	Boston, MA
3. Ernst & Young	Cleveland, OH	28. debis Systemhaus	Fasanenweg, Germany
4. Deloitte Consulting	New York, NY	29. PA Consulting Group	London, United Kingdom
5. CSC	El Segundo, CA	30. Woodrow Millman	Seattle, WA
6. KPMG	New York, NY	31. Origin	Eindhoven, The Netherlands
7. McKinsey & Company	New York, NY	32. Telcordia Technologies (formerly Bellcore)	Morristown, NJ
8. Cap Gemini	Paris, France	33. Buck Consultants	Secaucus, NJ
9. Mercer Consulting Group	New York, NY	34. Metzler Group	Chicago, IL
10. Arthur Andersen	Chicago, IL	35. Roland Berger & Partner	Munich, Germany
11. A.T. Kearney	Chicago, IL	36. Technology Solutions Company	Chicago, IL
12. Towers Perrin	New York, NY	37. Whittman-Hart	Chicago, IL
13. Booz-Allen & Hamilton	McLean, VA	38. CTG	Buffalo, NY
14. IBM Consulting	Somerset, NY	39. CBSI	Farmington Hills, MI
15. American Management Systems	Fairfax, VA	40. Renaissance Worldwide	Newton, MA
16. Keane	Boston, MA	41. Hay Group	Philadelphia, PA
17. Hewitt Associates	Lincolnshire, IL	42. Mitchell Madison Group	New York, NY
18. Sema Group	Paris, France	43. Perot Systems	Dallas, TX
19. Logica	London, United Kingdom	44. INS	Sunnyvale, CA
20. The Boston Consulting Group	Boston, MA	45. McGladrey & Pullen	Schaumburg, IL
21. Watson Wyatt Worldwide	Bethesda, MD	46. CIBER	Englewood, CO
22. DMR Consulting Group	Montreal, PQ, Canada	47. Monitor Company	Cambridge, MA
23. CMG	London, United Kingdom	48. Fust Consulting Group	Long Beach, CA
24. Aon Consulting	Chicago, IL	49. Horwath International	New York, NY
25. Cambridge Technology Partners	Cambridge, MA	50. Hagler Bailly	Arlington, VA

Critics lashed out at the new idea terming it as another fad. And the theory itself suffered from two major occurrences. First, the re-engineering idea got commoditized with several other management consultancy firms coming out with similar sounding variants of the theory. Secondly, the concept suffered a backlash with growing public anger against downsizing. The generators of the idea are no more with the firm.

The story of how Figgie International, once a conglomerate, had to file for bankruptcy owing to its consultancy's advice to introduce "world-class manufacturing" does tell a sordid tale about consultancy flaws. The story goes that Figgie managers would arrive at work and find teams of consultants they had never met before wandering around reorganizing everything. The company's sales collapsed to \$319 mn in 1994 from \$1.3 bn in 1989; during the same period, its profits of \$63 mn turned into losses of \$166 mn. The company also had to slash its workforce from 17,000 to 6,000. Disenchanted with its reversal in fortune, the company accused the consultants of

everything from lousy advice to using cash advances to finance visits to seedy entertainment joints in Dallas and New York. The company had spent a whopping \$75 mn on consulting advice.

The disgraceful collapse of Enron has shown how disastrous some of the so-called management practices, such as the "tight-loose" management practice, could prove to be while put in a real life situation. The energy trading company's policy to allow managers to take risky bets in new business areas without minding the cost of such investments saw reckless investments by the company executives in as varied businesses, mostly non-core, as steel, water, coal, and weather derivatives. Most surprisingly, the company used to award those managers who took risky bets even if they failed.

Needless to say, such illogical ways led to such an unfortunate end for the once high-flying energy trading company. And, much of the blame for corporate America's biggest collapse goes to the ex-consultancy guy, Jeffrey Skilling, the then CEO of the company. It is being said that it was he who had sown the seeds of

Enron's collapse by throwing away the mechanism of proper checks-and-balances to the wind (read further about Enron's collapse in *Analyst's* January 2002 issue).

Another consultancy firm, which also suffered a lot of backlash is Towers-Perrin. The consultancy firm, which specializes in remuneration packages, sent almost identical reports on how to deal with diversity to about a dozen different clients. Was the firm trying to come out with the idea of a single pill that can cure all ills?

But for all the bad name the profession has earned for itself, the also-rans of the industry are also to be blamed to some extent. One example is that of re-engineering. Critics opine that consultants treated re-engineering as a cure-all for every ailment, and that they ignored the human side of management, sacrificing such intangible goods as commitment and creativity to short-term efficiency. The result was that re-engineering usually led to demoralization and disruption rather than the revolutionary improvements in efficiency as touted by its proponents. Re-engineering experts however admit that for many of these charges, consultants who either misunderstood the concept or failed to apply it in proper perspective should be held accountable.

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Nevertheless, the profession has its bright side as well. Who would forget the concept of disease management, developed by Boston Consultancy Group. The consultancy firm helped change the patient reimbursement system and helped its client create a billion-dollar industry. The project turned out to be the first in a series that challenged some of the health care industry's basic paradigms and ultimately changed the way patients interact with their doctors.

Results not reports

The time has come when the idea creators should start looking at things more in terms of quantifiable results, as barely producing glossy reports is not going to find many takers. For prospective clients, it is time they stop looking for those good-sounding fads (business transformation, revolutionary enterprise, etc.) and instead communicate to them what exactly they are supposed to do and what results they are expected to come out with. However, at the same time, it is also possible that this kind of result-obsession could lead to loss of objectivity.

If the outcome of a decision is not going to be favorable (for instance, in cases of mergers and acquisitions), which consultant would like to lose his fat fee? Second, it would be virtually impossible to decide whose idea was it, which actually clicked. Third, the definition of results may itself mean different things to different people. One consultant may boast the rise in stock price of the company as a mark of his success, while for another it could be networking of the system. Though not every consultancy

today strictly talks about result-oriented fee (*Analyst's* attempt to get any response from most of these consultancies proved futile), some like McKinsey and Bain do lay some amount of emphasis on results. For McKinsey, results mean building capabilities, for those who do not like jargons, it is transferring skills to the client company. Nevertheless, all these should in no way be taken as an excuse to give consultants an open-ended opportunity to keep exploiting the company's situation.

A positive outcome of this new emphasis on results is that now consultancies are focusing on solving problems through cross-functional teams. These cross-functional teams include employees of the client organization along with those from the consultancy firm. It is hoped the increased collaboration between client and

consultancy firms would yield results, which could be more tangible. Perhaps consultants could take a leaf or two from turnaround experts. The latest successful turnaround of Nissan is a case in point. Carlos Ghosn, the CEO of the French automaker, Renault, Nissan's alliance partner, came to fix problems at Nissan. He formed nine cross-

functional teams comprising of managers from different divisions to identify key problems and their possible solution, and motivated his team to find solutions on their own without offending outsiders (like customers, suppliers, and market experts) who gave valuable inputs. His turnaround strategy set a strong example for others to draw a lesson or two. Today, Nissan is back to its profit-making ways, thanks to a well thought out and more realistic approach taken by the team at Nissan. Its turnaround story tells another important fact that how without going through the trauma and tribulations of job cuts (a popular prescription by consultants), a company could re-deploy its workforce without compromising on productivity, and, at the same time, could achieve a meaningful austerity level.

Collective responsibility holds the key

Though it is true that the responsibility for most of the big corporate failures like the one at AT&T has been thrust on management consultants, it would be



totally wrong to spare the corporate executives completely. If credit for their company's success goes to them, they owe the responsibility for failures of their companies as well. Therefore, it is time now that the spirit of collective responsibility should rule the collaboration between a company and its consultancy firm.

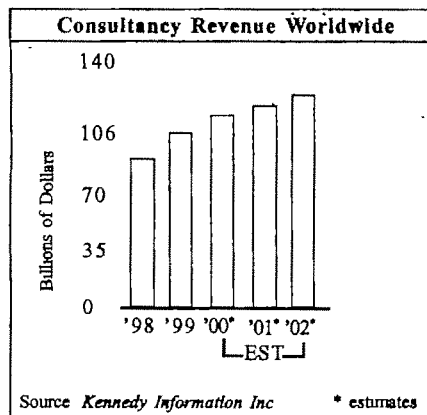
Not all corporate chiefs are rushing to consultants. Corporate veterans like Rupert Murdoch of Star Network, Hewlett-Packard, and J&J take pride in their in-house management capabilities and they are successful. There could be many more corporates who may not like to go in for consultants for the simple belief that if everyone gets similar advice from the same consultants, they might not have the arsenal to gain a competitive edge.

For the sake of shareholders and all stakeholders interests, corporate executives should always note that it is these people's money, which would be lost for any lapses on their part. Hence, if it is desirable that companies, when engaging a consultant, should be clear about the purpose of hiring them and also their price. As *Dangerous Company* suggests, give them (consultants) an open-ended assignment, like Figgie International, and it is bound to end in tears; give them a clearly-defined job subject them to rigorous performance appraisals, and some good might come out of it; so know your goal and stick to it. To quote from Machiavelli, "A prince who is not himself wise cannot be wisely advised, good advice depends on the shrewdness of the prince who seeks it and not the shrewdness of the prince or good advice." ■

Amit Singh Sisodiya, Team Analyst

Reference # 1-2002-05-06

A positive outcome of this new emphasis on results is that now consultancies are focusing on solving problems through cross-functional teams



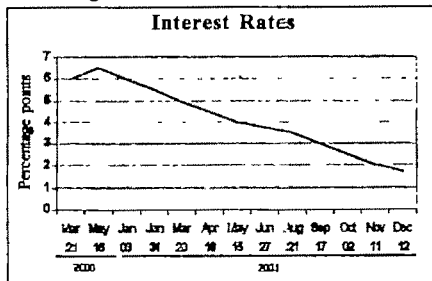
BUSINESS ENVIRONMENT

US Interest Rates

Reflecting the economic pulse?

The Federal Reserve has left interest rates unchanged. The Fed's subtle hints are that economic recovery is already underway and a cut in interest rates is not necessary while a raise will have to wait.

Central Banks, world over, have always considered the manipulation of interest rates as an imperative tool for regulating economic activity. For an economy expanding at an unprecedented pace, increasing the rates dampens economic activity. Similarly, for a sagging economy lowering the rates works as an expansionary tool for revival. This judicious mix of monetary policies enables the Central Bank to maintain economic stability. The Fed, and its celebrated helmsman, Alan Greenspan have always acted in the same spirit whenever the US economy showed signs of significant deviation from stability. The effort intensified when the country's finances were in the grip of an economic recession. Throughout 2001, the Fed ruthlessly slashed interest rates by no less than 11 times in a desperate effort to avoid the economic downturn. When the September 11 terrorist attacks pushed the US economy to the brink, the Fed promptly responded by further reducing the rates to a bare minimal, very close to zero. Currently the Fed's target rates are at 1.75 percent. However, without paying any heed to the rate cuts, the US economy has ended in a recession. The rate cuts largely proved the inefficacy of monetary policies in combating the devastating tidal wave of recession that had an equally grave cascading effect. Renu Kohli is also of the opinion that the indiscriminate interest rate cuts have not helped in avoiding the recession.



Market Indicators, mixed trends

Now, more than seven months after the terrorist attacks, the economy is finally showing early signs of recovery. The last months of 2001, which included the festive season of Christmas and the plethora of zero financing schemes offered by auto manufacturers acted in favor of the economy. The result was improved consumer spending, falling inventory levels, which in turn, expected to boost production in the coming quarters.

As per the business outlook survey, conducted by the Federal Reserve Bank of Philadelphia, the diffusion index of current activity remained positive for the third consecutive month but declined slightly from 16.0 in February to 11.4 in March. After 13 months of negative readings, the three months of positive indicators represent growing evidence of a recovery in the manufacturing sector. The percentage of firms (35), which have indicated an increase in activity, is more than those firms (24) that have indicated a fall in activity levels. The survey shows a positive trend in the new orders and shipments indicators. The new orders index recorded 7.3 declining from 13.7 in February while the shipments index recorded 7.7 as against 16.6 in February. Inventories have continued to decline albeit at a slower pace now. The inventory index improved from -14.8 to -7.1. Both the future prices paid and received indices increased. The index for future prices paid rose to 38.3 from 23.0 in February (highest in 16 months), while the future price received index 15.8 to 19.4 (highest in 24 months).

Though the indicators portray a very positive sign of economic recovery, skeptics question the very basis of the anticipation of economic recovery. Crying hoarse, they point out the fact that the debt levels of the households and business sector are still at all time high



levels. Public debt of US stands at more than 130 percent of its GDP. In fact, the extent to which American population has become dependent on debt is brought home by the fact that the aggregate household debt service burden (the ratio of household's required debt payments to their disposable personal income), has increased considerably in the recent years and is returning to its previous cyclical peak of mid-1980s. This high debt burden and the servicing charges in terms of interest and the repayment of the principal raise doubts as to the ability of household to spend. Nevertheless Alan Greenspan is optimistic that as of now the picture is not bleak enough to "pose a major impediment to a moderate expansion of consumption spending going forward."

Another intriguing factor is the balance of payments scenario of the US. The current account deficit of US is at all time high levels, at around 4.5 percent of the GDP. This itself is a major cause of concern. How America is going to cut down this deficit or how is it going to emerge as a growth engine despite this deficit is a question, which neither the Fed nor other authorities are trying to

address. *Financial Times* columnist Martin Wolf pointed out that the Fed's policy for a recovery, far from correcting the imbalances in the US economy, are increasing the debts and widening the balance of payments deficit. Though the present policies seem to be appealing, in the long run, this could bring about severe financial problems in the future. "The US, it is hoped, is now on its way to a demand-led recovery. The current account deficit is therefore likely to widen," observes Wolf. Goldman Sachs forecasts a rise in the US current account deficit from about \$420 bn last year (4.1 percent of GDP) to \$730 bn (5.9 percent of GDP) by 2006. At this rate of increase, the net international debt of the US, estimated to be \$2.6 tn at the end of 2001 and representing 20 percent of GDP, would rise to \$5.8 tn in five years, representing 46 percent of US GDP and about 15 percent of the rest of the world's GDP.

Maneuvering interest rates

During 2001, the manufacturing sector cut down production aggressively to limit excessive build-ups of inventories. In addition, businesses sharply reduced their investment spending. However, the response of the household sector was mixed, as mentioned earlier. Consumers, who had an overexposure to stock market, restricted consumption, lest their debt burden increases further. Others, who did not experience the erosion of wealth and were less exposed to the stock market, probably consumed more. Again, though the initial claims of unemployment are not applicable now, it is true that companies are seriously working on cost-effective ways of production. Though statistics indicate that the recovery has already begun, these issues remain unanswered.

Considering the economic indicators to be the true representative of the



"Fed's future plans to keep interest rates unchanged or raise it gradually is a sensible monetary policy."

*Renu Kohli,
Professor, ICRIER*

economic scenario, the Fed in its recent Federal Open Market Committee (FOMC) meeting has discarded any possibility of reducing the interest rates further. However, critics opine that the reason for not cutting the interest rates any further may lie somewhere else. According to them, the monetary policies of the Fed have largely proved to be incapable of combating the recessionary trend. Leveraging on the few positive indicators, the Fed is now trying to artificially portray a picture of economic recovery, though the reality is far from it. As recovery is largely driven by market sentiments, this sort of a hue and cry may create a positive impact on market sentiments, thereby leading to a real recovery. Though this kind of experimentation with the economy is challenging it may prove to be devastating in the long run. People may lose faith on the different tools of expansionary and contractionary monetary policies used to control economic activity.

However, there are economists who believe that the economy is truly on the way to a rebound. According to them, though a cut in interest rates is not warranted it may not be the right time either for a rise in the interest rates. On similar grounds, Professor Renu Kohli, Indian Council for Research on International Economic Relations (ICRIER), says that the time has not yet come for an upward revision of interest rates. According to her the economy should stabilize further. She feels that the stance taken by the Fed is an example of a sensible monetary policy. She subscribes to the view that any rise in interest rates at this point of time would lead to further deterioration given the fact that the household and the business sectors are

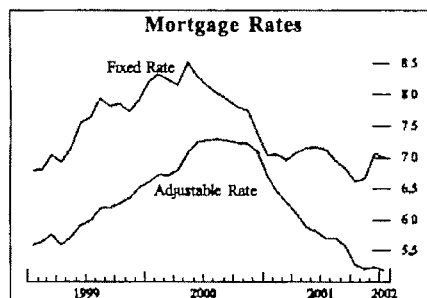
still neck-deep into borrowings and entrepreneurs are skeptical about new projects.

The positive thing is that volumes of international trade with the major partners are fast improving. The section of the household sector not witnessing the erosion of wealth may have a percolation effect on the other section, thereby improving productivity and growth. Nevertheless, the expectations about the year ahead are mixed. The IMF targets a growth of two percent in its *World Economic Outlook*. It has also observed that the imbalances across the globe have reduced. However, Fed notes, "the degree of the strengthening in final demand over coming quarters, an essential element in sustained economic expansion, is still uncertain."

Again, though the nominal interest rates are significantly low it is not reflected in the real interest rates. The low nominal interest rates coupled with even lower inflation rates have hundered the real interest rates from responding. The present 15-year mortgage rate in the US is around 6.5 percent p.a. as against the Fed rate of 1.75 percent. This has put the economy into a liquidity trap where any attempt to further reduce the nominal interest rates would be futile. The Fed having realized this opted not to reduce rates further following the Japanese way.

The Fed is now using its huge public relations machinery to indicate its optimism about the economic recovery. This could prove to be a self-fulfilling prophecy. The fact that Fed expects the economy to revive would be enough to boost the market sentiment. ■

DG Prasuna and Debasis Mallik,
Team Analysts



Note: The data, which are monthly and extend through January 2002, are contract rates on thirty-year mortgages from the Federal Home Loan Mortgage Corporation.
Source: www.federalreserve.gov

BY INVITATION

Corporate Governance in Banks

Setting new standards

Governance is in fact a reform package to strengthen the banks and corporates with the objective of making them more accountable, open, transparent, democratic and participatory. Good governance is equitable and effective governance that promotes the rule of law, says Sardar NS Gujral, Chairman and Managing Director, Punjab & Sind Bank.

It is now the turn of the banks to embrace the concept of corporate governance. Today corporate governance is being looked upon as a distinctive brand and the benchmark in the profile of banking excellence. The Milton Friedman's famous formulation that "the business of business is business" and the sole social responsibility of a company is to maximize profits for its owners (shareholders) has outlived its relevance. The corporations of today are no longer sheer economic entities. They are the engines of economic and social transformation, a corporation is a social institution whose responsibilities extend far beyond the well-being of its equity owners to giving security and a good life to its employees, dealers, customers, vendors, etc. Their whole life hinges on the well-being of corporation. The social responsibility and being a good corporate citizen have become the buzzwords in the international arena and assumed importance for long-term success of the corporations. Corporate governance and responsibility issues have come to the fore in response to three interrelated structural changes taking place in the Indian economy, namely Globalization of the economy, corporatization of the enterprises and institutionalization of the capital markets. The information technology revolution has led to dearth of distance, and facilitated communication at the speed of thought. People contact across the nations have now become instantaneous. In the exponentially shortening product and service life cycles, banks are required to continuously innovate, redefine and recreate and think out of the box and compete for marketing of their products and services and for meeting their capital requirements as well.

Globalization, among others, involves the movement of financial

capital to emerging markets both in the form of foreign investment and in terms of investment in the capital markets. Individual investors, funds, banks, foreign institutional investors base their investment decisions not only on company's outlook and financials but also on its reputation and governance. It is the growing need of the banks to access financial resources, both domestic and foreign, to improve their client base and also to increase their capital to meet capital adequacy requirements as per international accounting standards being implemented by Reserve Bank of India through financial sector reforms, which has brought corporate governance into sharp focus and has made it an indispensable requirement for survival, progress and growth. Regulatory bodies for capital market also feel that corporate governance is a requirement for the existence of any entity in the market as a whole and as a precondition to the listing requirement. As per clause 49 of the listing agreement all the companies in India including public sector banks bringing out their Initial Public Offers (IPOs) are required to comply with the conditions of corporate governance and obtain a certificate of compliance from the statutory auditors of the company and annex the same with the director's report to be sent annually to all the shareholders of the company/bank to the stock exchanges along with annual returns of the company.

The concept

Corporate governance is a way of life and not a set of hard and fast rules. It is a dynamic process. To govern means to rule or to control with authority and conduct the policy and affairs of an organization. In a generic sense,



governance refers to the task of running a government or any other entity like school, college and trust, etc. But over years, it has come to acquire a wider meaning. According to Justice MN Venkatachaliah, "An important distinction between government and governance is the notion of the civil society. Governance transcend the state to include civil society, organization and the private sector. Governance involves moral, ethical and legal values framework under which business decisions are taken." A good corporate governance is a shared way of corporate functioning. It implies wide acceptance within, of a role of governance, which is transparent and is perceived as such. Corporate actions, as a matter of fact should conform to the letter and spirit in which the society allows them to function. Corporations must ultimately be good corporate citizens. Governance is in fact a reform package to strengthen the banks and corporates with the objective of making them more accountable, open, transparent, democratic and participatory. Good

governance is equitable and effective governance that promotes the rule of law. According to the Cadbury Committee, corporate governance is the system by which companies are directed and controlled. It is a system of making management accountable to the shareholders of the company for effective management of the company in the interest of the company and also with adequate concern for ethics and values. The quintessence of corporate governance is transparency, accountability investor protection, better compliance with statutory laws and regulations, value creation for shareholders and other stakeholders and societal value. It is a means to maximize shareholders value and investors confidence in the long-term, in a legal, ethical and transparent manner ensuring fairness, courtesy and dignity in all transactions of the company. Corporate governance pre-empt the need for government interference in matters of business. It promotes self-regulation. Corporate governance is a successful triumvirate of shareholders, directors and management in action. All play their enlightened roles to optimize the common good. Efficiency of all players is the touchstone of corporate governance.

Thus, in a nutshell, we can say corporate governance is a systematic and company-specific process by which companies are directed and controlled, to enhance their wealth generation capacity in a transparent and legal manner, which meets shareholders aspirations and societal expectations. Corporate governance is not merely about enacting regulation. It is about establishing a climate of trust and confidence. It extends beyond corporate laws. Its fundamental objective is not merely the fulfillment of the requirement of law but in ensuring commitment of the Board in managing the company in a transparent manner for enhancing long-term shareholder value. Corporate governance is much wider than mere transparency and disclosures and compliance. It calls for a paradigm shift in the role of Board and corporate directors. They need to be "evolutionary" and revolutionary, constantly, moving the companies towards higher level of creativity.

Benefits of Good Corporate Governance

Good corporate governance practices lead to

- Stability and growth of the company
- Higher investor confidence
- Reduction in risks and cost of capital
- Leveraging of competitive advantage in financial market
- Sustenance of long-term shareholder relationship
- Makes the company an icon and enjoys a position of pride
- Potential stakeholders aspire to enter into relationship with the company.

Corporate Governance in PSBs

Public Sector Banks (PSBs) are a dominant component of the Indian Financial System. They are the engines of growth of the Indian economy. Government is the sole or significant owner as well as the regulator of the PSBs. Each PSB is a separate corporate body created by Bank Nationalization Act. Though owned by the government, each PSB is judicially different from the Central Government. It is not an actual person but an artificial entity, which acts through its Board of Directors.

In the pre-reform period, most decisions w.r.t. interest rate to be paid or charged and whom to lend were externally taken. But recently there has been a significant move away from micro regulation by RBI. There is a shift from external regulation to internal systems and controls; therefore quality of corporate governance in PSBs becomes critical in the performance of entire financial sector and indeed the growth of financial sector as well.

Corporate governance is not merely about enacting regulation. It is about establishing a climate of trust and confidence

Role of Board of Directors in Corporate Governance

In India, as government is the sole or significant shareholder of the public sector banks and also the sole regulator of their activities, corporate governance has not been a prime area of concern to them so far.

Government wields special influence on PSBs' governance. It nominates almost all the directors on their boards, on behalf of the entire nation. Corporate

governance envisages major role to the Board of Directors. It is the focal point of the governance process as well as the fulcrum of accountability in the system. They are the developers and monitors of the corporate conduct and performance. They are the guardians of the respective banks and their shareholders, if any, and are not solely their advisors or passive supporters of the management. The boards are responsible for not only ensuring compliance with the regulatory requirements but also to be responsive to the expectations of all the shareholders and stakeholders who deal with the bank. Board of Directors follow the twin objective of enhancing customer satisfaction and shareholder value. Board is responsible for evolving strong mechanism/framework for transparency, accountability and integrity. The functioning of Board of Directors of PSB is regulated by RBI/Ministry of Finance as per Nationalized Banks (Management and Miscellaneous Provisions) Scheme 1980. According to clause 7 of the above-said scheme, the Board of Directors is vested with the powers of general superintendence, direction and management of affairs and business of the bank. It is entitled to exercise all such powers and do all such acts and things as the bank is authorized to exercise. Directors other than the managing director or a whole-time director are not the employees of the bank. They are deemed to be public servants for the purpose of chapter IX of Indian Penal Code. However, the Board of Directors of PSBs enjoy sufficient operational freedom, which is conducive to adoption of corporate governance in PSBs.

To improve corporate governance in PSBs, RBI is following the recommendations of Basel Committee and has introduced several prudential accounting norms to fall in line with the international standards. At present banks are required to maintain capital adequacy ratio of nine percent, which is being progressively increased. Besides internal accrual of funds, banks are tapping the capital markets to meet their increased requirement of capital. With the entry of individual and institutional shareholders, their ownership is becoming broad based. The market price of banks' shares depends on their financials and quality of governance. With the introduction of clause 49 in the listing agreement, SEBI has made it mandatory for PSBs going public, with their IPOs to comply with corporate governance requirements.

CORPORATE GOVERNANCE IN BANKS

Banks are now required to disclose their performance on quarterly basis on the prescribed format.

Constitution of the Board

Each bank shall have a maximum of 15 members on its Board. In terms of Section 9(3) of the Banking Companies (Acquisition and Transfer of Undertakings) Act 1980, the Board of Directors of a bank shall consist of

- Not more than two whole time directors
- Two official directors representing the Central Government and the RBI
- Not more than two directors from the specified institutions having not less than 51 percent of paid up capital held or controlled by Central Government
- Two employee directors representing workmen and officers
- The chartered accountant director
- Not more than six directors to be nominated by the Central Government or elected by the shareholders.
- The predominance of non-Executive Directors is aimed at enabling the Board to take an impartial and objective view of the operations of the bank.

The Board is required to meet regularly, retain full and effective control over the bank and monitor the executive management. As per Nationalized Banks (Management and Miscellaneous Provisions) Scheme 1930, Board shall ordinarily meet at least six times a year and at least once in every quarter. However as per practice, Board and MCB meeting is normally held once in every month.

Committees of Directors/ Executives

In PSBs, as per the guidelines of Government of India and Reserve Bank of India, various committees have been set up with well-defined responsibilities to help the Board in quick decision-making and to monitor various areas of operations.

The important Committees are

Management Committee of the Board (MCB): MCB exercises powers vested in the Board in respect of most of the operational areas of the bank, such as:

- Sanction and review of credit proposals
- Investments in government and other approved securities, shares and debentures of companies
- Compromise/write off proposals
- Approval of capital/revenue expenditure

- Filing of suits/appeals
- Any other matter referred by the Board.

The MCB has the following members

- Chairman and Managing Director—Chairman of the Committee
- Executive Director
- Director—Government of India nominee
- Director—Reserve Bank of India nominee
- Director Representative of officers
- Director—Representative of workmen by rotation
- The CA Director.

Audit Committee of the Board (ACB): PSBs have constituted ACBs as per RBI guidelines. ACB oversees the overall inspection and audit functions in the bank. ACB is charged with the responsibility of ensuring efficacy of entire internal control and audit function in the bank besides compliance of inspection reports of RBI, internal inspectors and concurrent audits of the bank. Following are the members of the ACB.

- Director—Nominee of Government of India—Chairman of the ACB
- Director—Nominee of RBI
- Executive Director of the bank.

The Committee is required to meet at least once in every quarter and not less than six times in a year.

Asset-Liability Management Committee (ALCO): As per RBI guidelines, banks have constituted ALCO for putting in place a comprehensive asset-liability management system and for upgrading from time to time the internal risk management system. ALCO is headed by Chairman and Managing Director. Other members of ALCO are

- Executive Director
- General Manager (Planning)
- General Manager (Operations)
- General Manager (Investment)
- General Manager (Information Technology).

ALCO periodically reviews and monitors the liquidity and interest rate patterns w.r.t. prudential risk limits set by the Board, funding pattern, product pricing, fixing of interest rate of deposits and lending rates, etc. This Committee is required to meet once in a fortnight.

Investor Grievance Committee (IGC): The listed public sector banks are required to set up an IGC to look into the redressal of shareholders' grievances w.r.t. transfer of shares, non-receipt of dividend warrants, etc. Following directors are the members of IGC.

- Director—RBI nominee—Chairman of the Committee
- Executive Director of the Bank.

Besides the above framework for corporate governance, banks are required to furnish information w.r.t. the following to shareholders

- Annual general meeting of shareholders
- Disclosures standards
- Code of ethics
- Perception of insider trading
- Control on price-sensitive information
- Financial reporting and financial controls
- Timely reporting of financial results
- Constitution of Board of Directors
- Powers of the Board
- Role of non-Executive Directors
- Tenure of office of non-Executive Directors.

Conclusion

Corporate governance in banks is in a formative state. It is fast evolving and has a long way to go. While setting accountability standards for Board, there is a need for enhanced transparency and disclosure in respect of various aspects of Board constitution and functioning.

Corporate governance calls for a paradigm shift in the role of the Board and corporate directors. They need to be "evolutionary" and "revolutionary", constantly moving the company towards higher level of creativity. While corporate governance is an important element of affecting the long-term financial health of banks, it is only a part of larger economic context in which banks operate. The corporate governance depends upon legal and institutional environment.

It will be right to conclude with the remarks of Dr. YV Reddy, Deputy Governor, RBI, that the road to efficacy lies in minimizing regulatory prescriptions and maximizing voluntary codes to ensure excellence in corporate governance among financial intermediaries. Corporate governance is the only royal road to the portal of corporate success and there is no short cut to achieve the same. As short cutting can lead to short circuiting which can cause colossal loss to the banks concerned.

According to Dr. Sanjeev Reddy, "Corporate governance is a necessary condition and not a sufficient condition for succeeding in the global marketplace. As we move towards knowledge society and witness center of power shifting

Good Corporate Governance Practices

- Each bank should have a specific code of governance to achieve high standard of corporate behavior duly approved by its Board and made known to public.
- Composition of the Board should be broad based through induction of independent directors.
- Openness, integrity and accountability should be the key element of corporate governance.
- Functioning of Board should undergo qualitative changes to meet the expectations of all the stakeholders.
- The post of Chairman and Managing Director should be bifurcated so that Chairman is free from operational matters and is able to give focused attention to the working of the Board. Chairman should be the Chairman of Board of Directors and Managing Director (MD) should be the CEO of the Bank. MD shall exercise all such powers and discharge all such duties as may be delegated to him by the Board. He will be charged with the responsibility for the efficient management of the bank on behalf of the Board. It is through him the policies, decisions and programs approved by the Board are to be made effective and it is through him the Board will get responses and reaction of those at various levels of the organization, to its deliberations. He will interpret the policy decided by the Board to the employees of the bank and issue instructions in pursuance of the Board.
- Men of eminence who can contribute towards vision, control and guidance of banks should be chosen as directors through a High Powered Search Committee to be formed for this purpose, for preparing a panel of independent non-official directors who should be experts from different fields.
- Board should have a formal schedule of matters reserved for them for decision to ensure that direction and control of the bank is firmly in their hands.
- Non-Executive Directors should be conversant with the banks' operations and should be given orientation and training to make them abreast with the working of the bank, before appointment on the Board of banks.
- Non-Executive Directors should bring independent judgement to bear on issues of strategy, planning, direction and control of banks.
- Re-appointment of non Executive Directors should be based on the objective appraisal of their past performance by the Board.
- CMD should have a minimum tenure of three years to ensure proper direction and continuity of policy.
- Remuneration payable to non-Executive Directors for every Board meetings they attend, be revised upward and made market-related depending upon the contribution they make and time they spent on bank-related matters. Directors may be entitled to profit sharing as well. Board should be free to decide the remuneration for their own directors.
- Board of Directors should have power to recommend/propose anyone to work as a member of the Board based on his/her professionalism and expertise relevant to the particular field of activity of the bank.
- Board of Directors including its Chairman as well as Managing Director should have a say in the constitution of the Board.
- Selection of a director should be based on the relevance of his/her experience and expertise to the functioning of that particular institution on the Board of which he/she is invited to work.
- At least 50 percent of directors on Board of Banks should come through processes, which are independent of government intervention.
- Directors' responsibility to the Banks and other stakeholders must be clearly stated in law.
- The tenure of non official directors should be three years in a bank.
- Each Board should have the freedom to decide the upper age limit up to which a non-official director can serve on Board of the Bank.
- The role of independent non-Executive Directors on the Board of the Bank be clearly defined and made available to all sitting directors and also the newly appointed directors on assuming charge as a director.

away from shareholders towards the customers and the process of democratization of enterprises takes place, the links between excellence and governance will be much stronger in future. Banks must endeavor to achieve a dynamic equilibrium between expectation of owner (government and shareholders), employees, customers and other stakeholders to achieve excellence. While it may perhaps be difficult to establish one to one relationship between

financial performance of a corporate entity and levels of corporate governance, it is instead an essential element in performance standards and in enhancing shareholder value. Instead of waiting for total transformation to take place, it is right time to go for corporate governance in banks as it is better to light a candle than to curse darkness.

In competitive business environment, Banks that adopt good corporate governance and best practices will be

able to survive and attain sustainable growth levels. PSBs need greater functional autonomy in a deregulated environment. Such autonomy needs to be accompanied by greater accountability on the part of their boards to stakeholders. A code of governance shall serve as an effective instrument for achieving this goal. ■

Reference # 1-2002-05-08

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The views expressed in this article are those of the author and not that of Punjab & Sind Bank, of which he is the Chairman and Managing Director

BUSINESS ENVIRONMENT

Low Inflation

No loss, no gain

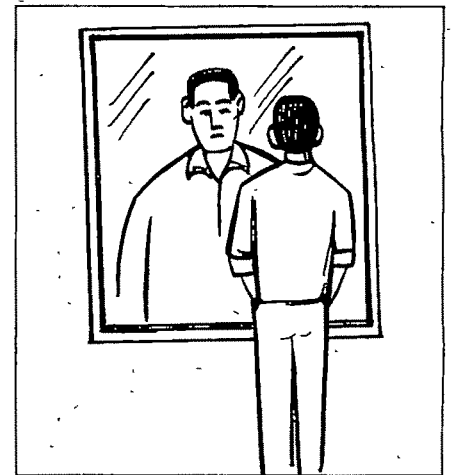
The low inflation scenario in India has neither created enthusiasm in the corporate sector nor has it increased the consumption propensity in the household sector. Is low inflation leading India to a deflationary situation?

An ardent follower of the economic data published by the Central Government will be glad to note that the inflation levels are hovering around one to two percent. Since the last couple of years the inflation rates are significantly low and since January 2002, they have slipped below the two percent level. What does this mean to India Inc.? Are these rates reflecting a true picture of the state of the economy? What about the issue of high real interest rates when compared to other countries? Is this an indication of the economy moving into a disinflationary mode?

What is inflation and how does it affect the economy? When there is a continuous rise in the price level, it is referred to as inflation. Put it simply, inflation is when you pay a higher price for the same commodities purchased over a period of time. While disinflation is a decline in the rate of increase in average prices, deflation connotes a sustained fall in prices. In India, the Wholesale Price Index (WPI) is the most popular method of measuring inflation compared to the Consumer Price Index (CPI), which is used widely across the globe. There are reasons for this. The basic advantage of having WPI

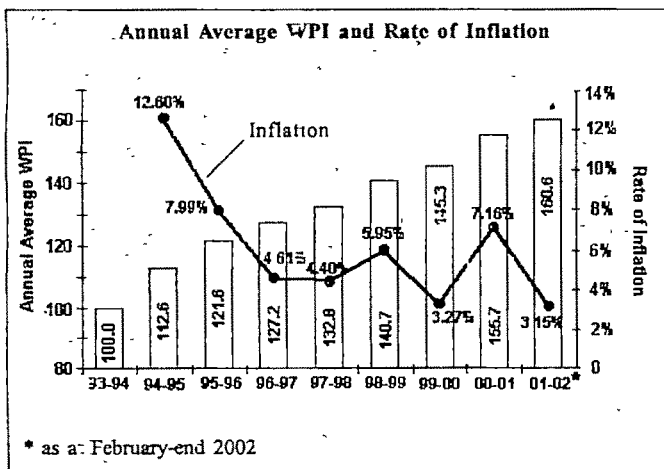
as a measure of inflation is its availability at high frequency, i.e., on weekly basis with a gap of about two weeks, thereby enabling continuous monitoring of the price situation for policy purposes. CPI is compiled on a monthly basis and it requires a regular survey from a highly dispersed market, which is quite difficult in a developing country like India. Getting back to the inflation levels that India is presently experiencing, are these levels indicative of the maturity of the system? Or is this a mere accident? Has inflation been tamed?

Skeptics of WPI-based inflation accounting allege that the method fails to capture the true nature of inflation prevailing in the economy. To some extent this is true, as the services sector, which accounts for around 50 percent of the GDP, has no representation in the bunch of goods considered to measure inflation. WPI takes into consideration manufactured goods, which constitutes a mere 17 percent of GDP. Continuous price changes taking place in the rest 83 percent of the goods and services market is completely ignored while calculating WPI. This makes the WPI in its entirety a false representation of the inflation rates



as compared to developed countries. To quote P. Balakrishnan, Professor of Economics at IIM-Kozhikode, Kerala, "In India we leave out the price of services such as rent and interest rates. This could understate inflation when the price of services rises faster than the general price level, as has happened in the case of housing sector in recent times." However, this matter is being addressed as the industry ministry has asked the Reserve Bank of India (RBI) to prepare a list of services including banking and insurance services that will be used for the new business services price index.

For developing countries like India, inflation is not just an economic indicator; it is a sensitive issue, both politically and economically. When elections are around, the Government in power tends to peg the inflation rates by restrained policy measures. Moreover, as low inflation rates imply economic stability, they enable the Government to attract Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII). Thus they often tend to do a window dressing exercise and tamper with the inflation rates. For example, the WPI as of now records price movements of over 400 commodities. There is room for the authorities to replace a highly price-sensitive commodity with a commodity that is relatively stable in price. This follows directly from the definition of inflation, which considers only those goods and services, which experience a

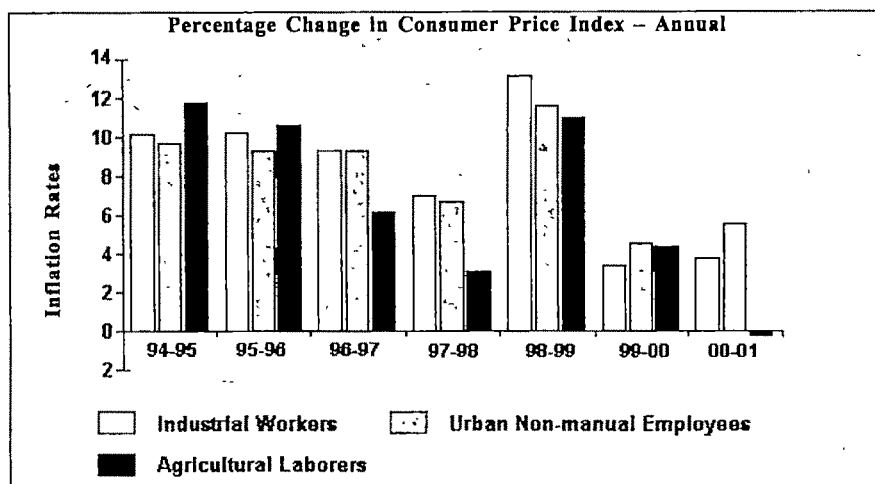


sustained rise in prices. Therefore, items that witness a sudden price change (rise or fall) are not considered to reflect an inflationary situation and are immediately removed from the list for accounting WPI and CPI. However, Professor Balakrishnan contradicts this view. He says "I do not believe that there is any element of manipulation in the method of selecting items in the CPI and WPI. In any case inflation has not been a major problem in India since 1991."

Is India Inc. benefitted?

In the last two decades, India has seen inflation rates consistently falling from ten to five percent and then to the present levels of less than two percent. Have these low levels of inflation benefitted corporate India in any way? At these levels of inflation rates, the issue of high real interest rates arises. The level of real interest rates provides a true picture of the real burden of debt and the ability to service debt. Presently, real interest rates in India are fairly higher than those in US, Japan and the Euro zone, where the inflation levels are almost touching the zero levels. The debt burden of corporates increases considerably with high real interest rates. Hence, there is a pressing need for the adjustment of nominal interest rates in India. The current regime of low inflation rates is creating tremendous pressure on the bottom lines of the business sector. The reason is, though there is a consistent fall in the prices of the end products, the input costs are witnessing a steady rise.

The falling inflation rates are acting as a disincentive to the corporates to set up additional capacities. Concurring to this opinion, Professor Balakrishnan says, "The favorable implications of low inflation rates to India Inc. are very few.



Declining inflation has done nothing to increase investment. Industrial production over the past five years has been directly related to the (declining) inflation rate." The industrial sector is struggling to cope with overcapacity, cheap imports and weak demand. The poor prices exemplify the slump Indian industry has been going through, where stiff competition and surging imports are eroding manufacturer's pricing power. Prices of manufactured goods have fallen nearly one percent in the past eight months, dragging down the WPI that has a 60 percent weighting in manufactured goods.

Heading for a deflation?

It is often said that mild inflation is good for a developing economy like India. This is because a slow rise in prices of both inputs and manufactured goods encourage investors to invest and they clearly foresee the margin of benefit. Though an element of money illusion is present in the case of mild inflation (which ranges between four to six percent) this is often misunderstood by the investing

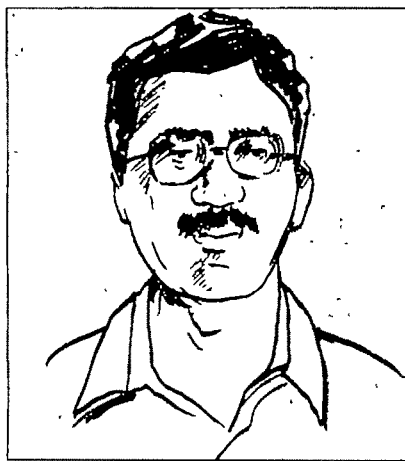
community and appears as future potential profits. The present situation of Indian economy is precarious since there is no mild inflation that will encourage the investors of any possible profits in the future. On the contrary, these low-level inflation rates can be a precursor to a looming deflationary spiral. Consumers in a deflationary environment tend to postpone spending expecting prices to fall further, leading to a rapid economic slowdown. Consider this example. Those who bought air-coolers in Mumbai a year ago may be regretting now for the appliance is at least 12.5 percent cheaper.

Skeptics may further turn back to the great depression of the 1930s for the impact of deflation. Then, the contraction in spending induced a fall in the prices and the decline in the economic activity inflicted further wounds. People and businesses earned less to pay their debts and this forced the prices to come down further in a process that economists call a deflation-debt spiral.

The APM tangle

The Government of India has from April 1, 2002 deregulated the oil sector and dismantled the Administered Price Mechanism (APM). This means that henceforth oil prices will be market-driven. Till now the Government used to decide the prices of the petro products. It kept the prices of diesel and petrol pegged at a level lower than the market rates providing a subsidy to the sector.

This had manifested in the form of a huge oil pool deficit. As the prices of petro products are now market determined, it is going to rise significantly. Considering the fact that petro products form a key part in the WPI, its prices will directly have an adverse impact on the inflation levels.



"The dismantling of APM and the possible rise in oil prices are not going to have an adverse impact on the long-term inflation rates, for the world price of oil may be expected to fluctuate."

*P Balakrishnan,
Professor of Economics,
IIM-Kozhikode, Kerala*

LOW INFLATION

"The funny thing about inflation statistics is that they hide more than they reveal."

Dr. Atmanand, Associate Professor of Economics, Management Development Institute, Gurgaon, Haryana and Editor, *VISION*, Journal of MDI

□ *If we compare the method of measuring inflation in the developed nations, where does India stand?*

Simply put, inflation is the rate at which prices rise. Prices go up essentially due to two reasons: Cost-push factors and demand-pull factors. In the latter kind of inflation, we have too much money chasing too few goods and prices tend to rise because people are largely willing to pay more money for the same item just because they have more money at their disposal. As against inflation, we have deflation, a situation of falling prices. The developing countries have rarely faced deflationary conditions.

On the method of measuring inflation in India as compared with developed nations, I would say that in India, inflation is measured by variation in three sets of price indices, namely, the Wholesale Price Index (WPI), national income deflator and the Consumer Price Indices (CPI). The WPI is compiled for all commodities as well as major groups, sub-groups and individual commodities. The computation of WPI is based on the Laspeyre's Index i.e., the weighted average of price relatives (current price divided by the base year's price) with base year's quantity as fixed weight. Weights are assigned to the commodities, sub-groups and major groups on the basis of the value of the wholesale market transactions. The basic advantage of this method is its high frequency availability, which is continuously monitored. The limitation of this method is due to low coverage and hence it does not capture the price increases in the non-commodity sectors, like services, etc.



The other method, national income deflator is a comprehensive one, derived as a ratio of GDP at current prices to GDP at constant prices. It includes entire economic activities including services, its scope and coverage are much wider than WPI. But this is not used, as the GDP deflator is available annually with a lag of two years.

The CPI, on the other hand, reflects changes in the retail prices of selected goods, in the basket of goods of homogenous group of consumers. This is computed on a monthly basis using the Laspeyre's index. There are three types of consumer price indices for: Industrial workers, urban non-manual employees and agricultural laborers. The weights are assigned on the basis of results of the respective family budget surveys. There are two types of problems associated with measuring of inflation. At the first instance the

problems are more of transitory phenomenon which arise due to energy price shocks, exchange rate variations, seasonal patterns, changes in indirect taxes. The second type of difficulty is mainly due to biases inherent in the weighting schemes, sampling and adjustments.

□ *Do you think that there is an element of manipulation in the method of selecting items in the CPI and WPI, deliberately to portray a low inflation rate to project a favorable picture to foreign investors regarding the business environment in India?*

First of all, I would like to state that low inflation rate is not the factor for attracting FDI in India. Part of the reason for increase in FDI inflows in India is the fact that MNCs are in a consolidation phase. With sectoral caps being further liberalized, they are in the process of either setting up wholly owned subsidiaries or hiking stakes in existing joint ventures through takeovers.

There is an element of manipulation in the method of selecting items in the CPI and WPI. Take the case of WPI. The base of the new series of WPI has been shifted to 1993-94 from the series with 1981-82 as the base year. The new series has covered 435 items in the commodity basket with 98 primary articles, 19 fuel group items and 318 manufactured products. The new series considered only commodity producing sectors and has followed the same sectorization as the previous series. The key issues involved in the accuracy of WPI calculation are the selection of the products and the weightages assigned to these. WPI figures so calculated are wanting in both these

Earlier, the changes in prices internationally were not reflected in the national scenario, thus resulting in the portrayal of low inflation rates. Now in the post-APM regime, petroleum companies can decide the prices based on international oil prices ultimately affecting the inflation levels. However, Professor Balakrishnan argues, "The dismantling of APM and the possible rise in oil prices are not going to have an adverse impact on the long-term inflation

rates, for the world price of oil may be expected to fluctuate."

Whither the common man?

The inflation levels, week after week, are reaching new lows. How does this affect the common man? Commenting on the issue, Professor Balakrishnan says, "Of course prices have been rising—almost, continuously—but of late they are rising at a progressively slower rate." One should never get

confused with inflation levels and the true price levels. Although WPI, measured on the basis of items like fertilizers, industrial raw materials, semi-finished goods, machinery and equipment, etc., has been falling consistently, the CPI, which is a true indicator of the prices at the consumers' end has not been falling with the same pace. Time and again, inflation trends in the WPI and CPI show contrasting trends. The WPI can be interpreted as an index of

areas. Ninety percent weightage in WPI is assigned to primary articles and manufactured products. These products when seen as a percentage of GDP constitute just 45 percent. This in turn means that WPI does not capture even 50 percent of the output of the economy. The sectors not included are service (20.2 percent); trade hotel and restaurants (13.5 percent); transport and communication (5.3 percent); and banking and finance (10.6 percent).

Though the service sector has largely been neglected in the WPI, if included, its effect on the recalculated inflation index is significant. In conclusion, the official figure of WPI is an overstatement of actual inflation in the economy due to misplaced weightage assigned to primary articles and manufactured products. The composition of GDP has been undergoing a change with share of agriculture getting reduced and that of service sectors considerably increased. Apart from giving a very broad idea of the price situation, the WPI is limited in terms of basic purpose. For example, to calculate the measure of real interest rates, which are so crucial for investment decisions by corporates, price indices specific to sectors and product lines need to be used.

□ **What are the implications of a low inflation rate to India Inc.?**

Extremely low inflation signifies a demand slump. That seems to be the case today. The manufactured products component of inflation has averaged about 2.5 percent during April-December 2001, a historic low. It is a clear indication that demand is extremely low. The majorities are seeing prices come under pressure because of already glutted godowns. The impact of low inflation has already been felt on interest rates. What really matters for India Inc. is the real rate of interest. The real interest rate is defined as the difference between the nominal rate and the rate of inflation. It is quite high. This reflects a summary of the cost of borrowing for a firm relative to pricing power

High real rate of interest keeps the cost of borrowing high and thereby curbs the incentive to invest leading to a vicious cycle of sorts with low demand feeding into poor investment which, in turn, keeps demand low. For the firms what is important is of course the future inflation rates not the rates of the past. Interest charges accrue in the future and that has to be matched with pricing power in future, which ultimately impact bottom lines. Both nominal rate of interest and real rate of interest are critical to the evaluation of an investment project of India Inc. The rate charged by the bank or financial institution represents their cost of borrowing. The pricing power is reflected in their cash-flow projections. The corporates are unable to increase product prices. The main reasons cited are severe competition, a price increase effected in the recent past, sluggish demand, recent hikes in dividend and service tax and a crunch in the export market. Corporate India's expectations regarding profitability have been moderate. Volumes are expected to expand and price realization could remain poor.

□ **For the common Indian it is perceived that prices in India are forever rising. However, inflation rates have a different story to tell. How do you explain this anomaly?**

While the inflation data that the government publishes every week are rate of change in WPI representing rate of increase in the wholesale prices of products, what matters to common Indian buyers are consumer prices. Though the wholesale prices have grown at a slow pace (2-3 percent), the consumer prices measured in terms of the CPI have tended to grow at a much faster rate (8-9 percent) comparatively.

The point of difference between the wholesale price and consumer prices is on account of retailer's margin, which is included in the price, what the consumer pays. While the wholesale prices are more or less same

throughout the country, the consumer prices or in other words, retail prices vary across different regions, rural and urban and also across different cities due to consumer preferences, supplies and consumer's purchasing power. Price variations are also caused due to taxes and duties imposed by states. The funny thing about inflation statistics is that they hide more than they reveal. It is quite imperative that the inflation statistics give a more representative picture true for the entire country.

□ **Any other issues you would like to raise.**

I would like to throw light on couple of related issues. In Indian context, price stability as an objective of monetary policy is important. Volatility in prices creates uncertainty in decision-making. Rising prices adversely affect saving while making speculative investments more attractive. Price stability is at times misunderstood as zero inflation, wherein associated costs may be high. Professor Krugman, Massachusetts Institute of Technology, writes, "The benefits of price stability are elusive, the costs of getting there are large, and zero inflation may not be a good thing even in the long run." In Indian context, the Chakravarty Committee (1985) treated an inflation rate of four percent as "the acceptable rise in prices", that reflect "changes in relative prices necessary to attract resources to growth sectors".

An alternative to WPI is the business services price index. This index would reflect the price movements of services such as banking, insurance, transportation, postal services and communications. Today the service sector forms 50 percent of the GDP. The need for the new index arises because the services sector is growing at a rate faster than the manufacturing sector. As a result, prices of services may grow at a faster rate. In the developed countries similar index is used in the name of corporate services price index.

prices to which producers may refer to. This has hardly any relevance with the common man.

It is the behavior of the CPI, which tends to portray the price changes of the goods and services, which the common man experiences. WPI reacts lesser to the fluctuations in food prices, because food articles have a relatively lower weightage of 15 percent in this index. On the other hand, food products move 57 percent of the CPI for industrial workers and over

69 percent of the CPI for agricultural laborers. It is very unlikely that these low levels of inflation are truly benefitting the common man as the prices of basic items are showing an increasing trend although at a slower rate.

Indian policy makers need to act fast in clearing the clouds surrounding the inflation levels. Falling inflation is beneficial only in the short run. In the long run, it can destroy the future objective of India of becoming a global economic

power. Avers Balakrishnan, "The recent history of India suggests that there is little reason to believe that growth would pick up as soon as inflation is reduced. Poor macroeconomic policy must be held directly responsible for the poor growth performance of the Indian economy since 1996." ■

Shashidhar Mishra, Team Analyst

Reference # 1-2002-05-09

INDUSTRY

Global Steel Industry

Looming trade war

With more than 30 steel companies in US having filed for federal bankruptcy protection since 1998, the country's steel industry is in deep trouble with prices at their lowest in 20 years. The Bush administration has resorted to protectionist tactics, but this could lead the President to fight another battle, unfortunately with his own trading partners.

The ailing US steel industry has been experiencing an extensive and painful restructuring process over the years. So far, it has spent \$50 bn for modernizing its plant and equipment and has laid off over 300,000 workers, nearly three quarters of its labor force. But nothing seems to be working out for them. In a desperate move, President Bush resorted to imposing import duties.

But why does the US steel industry need protection? The reasons are not far to seek. More than 30 steel companies have filed for federal bankruptcy protection since 1998. The industry is in deep trouble with prices at their lowest in 20 years. Industry observers say the main reason is the glut of cheap imports from countries such as Japan, Russia, China and South Korea, combined with steel overcapacity all over the world, which led to falling steel prices especially in North America. Every segment of the steel industry, regardless of the region, the size of the companies, or whether they use mini-mill or integrated production processes has seen its profitability suffer in recent years. Integrated and mini-mill producers have both called for action to address the market distortions in the steel sector and are also asking the government to impose Section 201 (safeguards) relief. However, the importing countries including European Union has objected strongly to the latest US move. And, the worst of all, it is threatening a trade war between the world's biggest trade blocs.

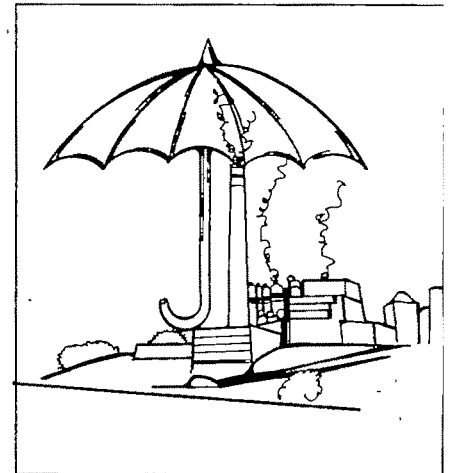
From "free" to "fair" trade

Given this background, the US International Trade Commission (ITC)

recommended that special duties of 5-40 percent on 16 categories of steel products be levied to protect its domestic industry. In total, these product categories represent some 75 percent of total US steel imports. In an effort to save what's left of a dying steel industry, the Bush administration embraced the idea of higher import tariffs up to 30 percent for steel from some foreign competitors for three years, claiming that other countries are dumping steel at below the cost of production and damaging its domestic industry. While announcing the new tariffs on March 6, 2002, President Bush said, "I take this action to give our domestic steel industry an opportunity to adjust to surges in foreign imports, recognizing the harm from 50 years of foreign government intervention in the global steel market."

However, with Section 201, US became the most protected steel market in the world. The introduction of tariffs marks an apparent reversal in US trade policy, which until now had preached the virtues of open trade. So, the near-collapse of the steel industry forced President Bush to shift from a "free trade" to "fair trade" position to save the steel sector. After decades of the US hammering away at the rest of the world demanding obedience to the gods of free trade, now the country is itself adopting a "fair trade" policy.

The Section 201 tariff decision has been met with anger globally, particularly in Europe and steel-producing nations in the Asia-Pacific region. The war between competing interests rages on at home and abroad



following President Bush's decision, which will have far-reaching implications domestically and abroad. Economists have fretted that the steel tariffs, which have provoked outrage in Europe and Asia, could be the first blow in a trade war that could undermine global economic recovery.

Import restrictions on the other hand will benefit no one. At home, the US steel industry responded to the President's announcement with price increases and warnings that there might not be enough steel to go around. In reaction, companies that use steel to make such products as lawn equipment, nuts, bolts and auto parts are warning of lay-offs and their businesses moving overseas. With the world on the edge of recession, any protectionist closing of the US market could have a ripple effect with far wider implications for the global economy.

A hot business going cold

American steel industry has done little to consolidate or rationalize. Instead they have continued to over expand and not allow antiquated facilities to close. The problem is not imports, but a case of

With the world on the edge of recession, any protectionist closing of the US market could have a ripple effect with far wider implications for the global economy

"It is time for the US Government to try free trade in the steel sector."

David Phelps, President, AIIS, Washington, USA

□ *On the possibility of trade war*

It appears that there is already a beginning of a trade war with the EU announcing preliminary safeguard measures, Canada initiating the beginning of an investigation and other countries like Mexico, Brazil and others announcing increases in tariffs in response to the protectionist 201 action taken by the US. In addition, the EU, Japan and others are also challenging the 201 remedy at the WTO, and threats of retaliation have been made, although whether that will happen before the WTO process works itself through is still an open question.

We at AIIS believe that the US Government should be taken to task at the WTO for its abuse of its obligations and forced into compliance by our trading partners. Steel imports declined substantially in 2001 and the WTO requires a substantial and unexpected increase in imports before imposition of a 201-relief program. We believe that a trade war by our trading partners will only spread the pain and economic losses from the US's bad decision and we hope that international pressure and the WTO process will result in the Bush administration coming to its senses and embracing the free trade approach, it says, it believes in. To do otherwise, will hurt steel consumers in the US and in the other countries that impose such protectionist measures.

AIIS believes in economic growth through free trade in steel. It is time for the US Government to try free trade in the steel sector—30 years of protecting, subsidizing and coddling the domestic industry has not created a competitive industry, merely a sense of entitlement by the weak companies who have shown that they cannot survive without Government interference in the marketplace.

□ *On WTO's role*

As noted above, the EU and Japan are leading a challenge to the 201 remedy imposed by President Bush. At this point it appears that they will follow the normal WTO complaint process, which will take about two years or so to complete. There are many wild cards in the deck, however, especially since the EU has already won an important case on export tax credits from the US and could impose retaliatory tariffs at any time.

□ *On the morality of US action*

The sad part of this decision is that the US did not have to impose any additional tariffs on steel—there are over 150 anti-dumping and countervailing duty orders in place on steel imports—to "save" the steel industry. The strong companies do not need the tariffs to survive, and the weak companies, many of whom are in bankruptcy already, will not be saved by such actions—they have benefitted from 30 years of protection and are so mismanaged that they are not profitable even with the 150 orders already in place.

□ *On the ailing US steel industry*

It is mismanagement, pure and simple. Take two companies, LTV and USS. They have the same union, the same wages and legacy costs, they buy the same iron ore, coal, ferroalloys, equipment and make essentially the same products and compete against the same imports. One is a strong company and the other went bankrupt twice and has been liquidated under Chapter 7. There is only one possible explanation left for the differences between the two companies, management. One is well managed and a tough competitor, the other, well, their experience speaks for itself.

□ *Outlook on the global steel industry*

The strong integrated companies will survive, and the mini-mill sector will continue



to grow. We experienced a nearly 50 percent growth in demand during the 1990s, and while the recession and the strong dollar have not been beneficial to that trend, the long-term flexibility of the US manufacturing base, along with the expected continued growth of the mini-mill sector are all strong positives for the steel and steel consuming sectors. The downside for all is if the Government continues to support the weak companies in the industry through protection and subsidies, the market will not be allowed to work and the weak companies will continue to be a drag on the steel market during periods of slow demand and, of course, also continue to demand more protection and subsidies. The experience in the recession of 2000-2001 is instructive. It was these weak companies, who in desperation to stay out of bankruptcy or continue in operation, cut prices over and over again to keep operating rates and cash flow up.

It was they who depressed the market, no imports, which declined over 20 percent in 2001 and over 33 percent since the peak in 1998, in response to weak demand and poor pricing. For importers, the market does work

overcapacity within the US. Repeated protection for 30 years have not solved the industry's basic problems of outdated production methods, fragmented structure, high costs and poor labor relations.

Instead of encouraging the industry to restructure, the long-term protection has sustained inefficient companies and cost

US consumers dearly. As Anne O Krueger, Deputy Managing Director of the International Monetary Fund, says in a report on Big Steel "The American Big Steel industry has been the champion lobbyist and seeker of protection. It provides a key and disillusioning example of the ability of special interests to lobby in Washington for measures which hurt

the general public and help a very small group." Another way to say this is that for each dollar American taxpayers and consumers pay for steel protection, perhaps 50 cents benefits owners and workers at big US steel companies and the other 50 cents is wasted.

Since the 1950s, the US Big Steel (integrated steel companies) have been

GLOBAL STEEL INDUSTRY

"The prospects of a trade war will increase among the steel producing countries and among the steel exporting countries."

Susmita Dasgupta, Deputy Chief Economist, Joint Plant Committee (Steel)

□ Do you think that the recent tariff imposition of import tariffs on steel by the US will trigger a trade war between the major steel importing countries?

As far as the steel importing countries are concerned they are likely to benefit from the imposition of tariffs in the US. The steel exporters to the US are likely to compete among themselves and reduce the export prices. For countries that are importers of steel, steel will be cheaper. The prospects of a trade war will increase among the steel producing countries and among the steel exporting countries. Such countries are likely to find their export markets constrained by the US tariffs and also their market share threatened by increased competition. What is worse is that the individual countries may start adopting for themselves the same criteria as used by the US to protect its own industry. This will indeed have a telling effect on the openness of trade proposed by the WTO.



□ What impact will the tariffs have on world steel exporters? What can the rest of the world do about it?

The imposition of tariffs will indeed restrict imports by the US and since the country is a large importer of steel, it will indeed ward off a large quantity of steel from its own market. This means that a lot of floating supplies of steel will

be available in the market that may send the prices down. World steel prices are likely to fall further. The overall fall in world prices will make imports cheaper in the US despite the tariffs and imports may in fact increase as a result of its own tariffs. The US had itself envisaged this problem and moved the OECD to issue multilateral talks among the countries in the world in order to voluntarily cut capacities. How they will do so is not immediately evident and in all likelihood this will mean an exit of bankrupt companies. If this were the case, then it will mean that 30 percent of the US firms exit because such is the percentage of bankruptcy of the US steel producers. But, the US's actions and the chain of events consequent upon it will force the steel producing nations to seriously consider the closing down of steel producing capacities in case of default.

□ Where does the WTO figure in this stand off between the US on one side and the EU and the rest of the world, specially the EU, on the other?

reluctant to make the investments needed to match the new technologies introduced elsewhere. It was slow to replace open-hearth furnaces with basic oxygen furnaces and was late in introducing continuous casting. Big Steel also acquiesced to high wages for its unionized labor force. Hence, these companies have difficulty not only in competing with more efficient producers in Asia and Europe but also with technologically advanced US mini-mills, which rely on scrap metal as an input.

Its only hope of survival lies in shrinkage, consolidation and mergers rather than artificial protection from pressures to restructure. The Government had recently announced a \$15 bn rescue package for airlines, and now a likewise bailout for steel would be an invitation to other industries to demand similar largesse, which could damage the US economy irreversibly and also create global repercussions. So is President Bush correct when he imposes steel tariffs? In what way is Uncle Sam right to compete with India or Brazil to make steel slabs? David Phelps, President,

American Institute for International Steel (AIIS) which represents exporters and importers in Washington D.C., is of the view that President Bush's decision to impose tariffs on steel imports will hurt steel consumers and will not solve the problems of weak, mismanaged steel companies in the US.

Worldwide repercussions

The announcement of tariffs on steel imports is threatening a trade war between the world's biggest trade blocs. The EU, Japan and other steel producers maintain that their companies are more efficient than American producers. Japan became the latest country to file a complaint against the tariffs with the WTO in Geneva to battle the "unfair" safeguard measure. The EU had already filed a formal complaint with the WTO, although that could take months to resolve. With growing job losses throughout the industry, the EU and Brazil have demanded compensation from the US for lost imports and threatened to impose retaliatory tariffs of their own. South Korea is planning to

lodge a formal complaint with the WTO. Meanwhile China is also preparing to launch its first WTO complaint since joining the global trade body last year.

Some steel producing companies in developing countries, including South Africa, have negotiated broad exemptions from the US tariffs, while two of America's biggest trading partners,

Country	February 2002	February 2001
Australia	119	16
Brazil	435	210
Canada	436	360
China	69	97
EU	494	394
India	28	4
Indonesia	9	8
Japan	225	101
Korea	235	218
Mexico	136	190
Russia	325	113
South Africa	9	11
Turkey	127	30
Ukraine	132	27
Others	270	185
Total	3,048	1,964

So far, the WTO has been neutral on the matter. The US has imposed tariffs in defense of its own industries, as nearly 30 percent of the steel-producing firms are today bankrupt in that country. This is one thing, but the EU's imposition of a retaliatory duty on US imports will indeed start a trade war. I am not certain whether revenge and retaliation are among the provisions in the WTO. At an immediate level, the WTO is likely to support the US over the EU.

□ If the world's strongest economy requires such a high protection for its steel industry, then what right it would have to ask much weaker economies to lift their tariffs?

The US is seeking protection for its steel industry under the WTO-compatible guidelines and thus, the weaker countries can do the same as well. What is not WTO compatible is the fact how is it that the OECD multilateral talks can discuss capacity cuts in individual countries. If the OECD is going to persuade a market-based capacity cut for its member countries, we cannot quite comprehend why the process cannot begin with the US?

□ Do you think that the recent suffering of the US steel industry is because of its inefficiency, which has been creeping in over the years, and not because of the import threats?

I quite agree with the thesis that the problem with the US steel industry is with its own self and not with threats from imports. Today, 30 percent of the US steel industry is bankrupt which involves a capacity of 26.8 million tonnes of steel. In 1998, the US imported over 39 million tonnes of steel and in 1999 it imported 29 million tonnes. This means that the bankruptcy happened with falling imports. The fall in imports happened before the imposition of Section 201, which goes to show that the US economy is in a state of recession and the bankruptcy of firms may well be due to it than due to cheap imports. But nothing can be said certainly until and unless we work out a case-by-case analysis of the US steel industry. Today the US has imposed a tariff of 30 percent. The existing tariff was roughly at 10 percent before the imposition of Section 201. This is a 20 percent increase in the per unit price. Assuming other things remain unchanged, the 20 percent increase in price should increase profits by 20 percent. If a 20 percent increase in revenues is enough to set off bankruptcy, then we can indeed say that the US steel industry was being obstructed by cheap imports. If more than 20 percent increase in profits is needed to overcome bankruptcy, then we may assign the amount over and above 20 percent to the inefficiency of the US steel industry.

□ What is your outlook on the global steel industry in the long run?

In the long run, the global steel industry will start having a very different look. The excess capacities in the steel industry are likely to remain, but they will change their form of existence to a large extent. The steel industry, because of its excess capacity world over will look for global operations with a view to dissolve the excess fat. The "service" component of steel manufacturing will increase with higher value-added materials for diversified use. Fabrication, welding techniques, service centers and industrial hubs may emerge in order to fine-tune the bulk commodity into specific consumer needs. The conflicts such as the US may increase, because while the economics of steel production needs large concentration of capital, the economics of consumption will need smaller and specialized quantities. There will be a greater role of trade in the future as locations of production and consumption will diverge more and more. The more globalized firms will be better placed financially than the less globalized firms. We must be prepared to produce more in order to export more since the centers of production and consumption will vary greatly.

Canada and Mexico, would be exempt from the product-by-product tariff changes. Developing countries such as Argentina, Thailand and Turkey have also been exempted under free-trade deals. But steel producers in China, Brazil, Japan, South Korea, Norway, Ukraine, New Zealand, and Russia are expected to be hit hard by the US tariffs. OECD, the rich countries' think-tank, says that steel

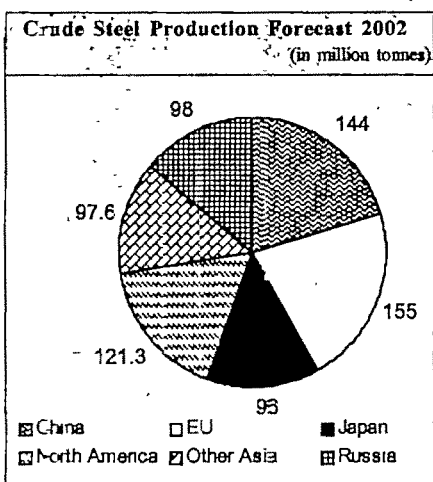
producers need to cut more than 100 million tonnes of capacity worldwide to restore the industry to profitability. The trade war comes just a few months after world leaders pledged to co-operate in launching a new trade round at a meeting in Doha, in the Gulf Arab state of Qatar. However, the US claimed its move was prompted by "unfair" government support for steel-makers in other countries, and is supported by WTO rules. Leaders of EU nations signed a declaration supporting the complaint to the WTO, and moves towards "possible safeguard measures". "The European Council has taken note with great concern of the safeguard measures introduced by the US in the steel sector which are not in conformity with WTO rules," the declaration says. EU steel-makers say they stand to lose \$2 bn a year to the US tariffs. Japanese Trade Minister Takeo Hiranuma warned that his country may retaliate with measures to protect its own steel industry. EU Trade Commissioner Pascal Lamy says that it would be "a question of days" before the EU issued quotas on steel imports to

prevent its own industry from being damaged by steel redirected from US markets. Lamy adds, "The US decision to go down the route of protectionism is a major setback for the world trading system."

A higher tariff to protect the domestic steel industry will probably come at a heavy price especially with reference to relations with countries that conduct friendly trade with the US. Fearing that cheap steel would flood their markets, other countries imposed their own tariffs. Some have threatened retaliatory trade barriers on US goods ranging from motorcycles to orange juice. It could spark a chain reaction, which could halt international trade in the commodity sector. The immediate danger is the risk of additional safeguard measures against imports of steel, taken by the EU. The US decision may thus trigger a chain reaction that could foreclose practically all export markets and bring international trade in steel to a total halt. Phelps says, "We are concerned that major US trading allies will close their steel markets in response, creating more protectionist pressure on

Country	Year end 2002	Year end 2001
Australia	165	46
Brazil	940	505
Canada	896	460
China	109	40
EU	968	474
India	88	60
Indonesia	14	5
Japan	486	261
Korea	440	205
Mexico	230	94
Russia	452	127
South Africa	63	54
Turkey	204	77
Ukraine	166	34
Others	516	246
Total	5,736	2,688

GLOBAL STEEL INDUSTRY



international markets and that retaliation against US exports of agricultural and other products will spread in an escalating trade war."

Will it be a right pill?

Given the US steel industry's chronic problems, will Bush's recent protectionist moves save it? Analysts say the best evidence of the fact that imports are not the problem here is that the prices of many US steel products already protected by high dumping duties have not increased. Even without imports, US steel producers are hurting themselves and each other by selling below cost. There is no assurance that the US industry will eliminate outdated steel making facilities and practices once it is "virtually shielded" from imports. "The President has made a courageous decision in the national

interest," says Andrew G Sharkey III, President and CEO of the American Iron and Steel Institute. "This decision will help return the American steel industry to health, and send the signal that America will no longer serve as the world's steel dumping ground." US Steel Chairman Thomas J Usher called the Bush's decision "a victory for everyone who cares about the future of the steel industry in America, and could help set the stage for revitalization of the industry." However, critics claim that these tariffs will hurt steel consumers and will not solve the problems of weak, mismanaged US steel companies. "Well-managed and competitive companies do not need the Government to guarantee profits via more trade

protection. It is American companies and workers who are going to pay the price for this remedy," says Phelps. Tariffs will raise the price of steel for US manufacturers, he says, while their global competitors will pay international market prices. The result will be job losses, as US steel-consuming industries will be forced to move their plants offshore to compete with foreign manufacturers.

On downstream impact of tariffs, Jon Jenson, Chairman of the Consuming Industries Trade Action Coalition (CITAC), US, says, "American manufacturers are angry about the tariffs, their interests were lost in the frantic political effort to appease steel producers and their unions. The tariffs come at a particularly bad time." Steel prices are rising dramatically, delivery lead times are lengthening, shortages are anticipated and customers are being warned about having their steel supplies rationed. President Bush, who pledged to lead the world to free trade, has departed from his principles to curry political favor.

The purpose of tariffs and quotas is to inflate prices, creating a new tax on American manufactured products. Jenson cites three studies released since

December 2001 that examined the potential impact of steel restrictions from several perspectives, all of which concluded that import tariffs and quotas would cost thousands of American jobs. "We're especially concerned now about downstream users who must import because their steel inputs are in short supply in this country or not available at all," he adds.

Donald F Barnett, a steel analyst and President of Economic Associates Inc., says domestic problems remain after Section 201—bankruptcies, capacity closures and restarts, and the viability of industry restructuring. Yet, the domestic industry knows the tariffs are temporary and decreasing. "They have to do something before the three years are up. If domestic producers raise prices and do nothing to cut costs or restructure, the tariffs will be removed." Whatever happens as a result of the Section 201 decision, Barnett believes mini-mills will gain a much larger share of the market within the next decade. "The tariffs provide an umbrella for them to capture a larger share because they can raise prices

a little less, and fill up their plants." However, critics say that tariffs alone are not the solution. US steel firms and labor unions blame cheap imports from 31 bankruptcies in the past. Countries opposing the tariffs say US woes are due to years of failure to restructure the steel sector and a strong dollar, which has risen 23 percent against the Euro in two years.

Outlook

The US action will lead to further efforts to re-establish protective tariffs worldwide. Clearly, the ongoing shift in US tariff policy is a direct threat to the WTO. The EU will be the biggest loser, but the losses will be felt from the Americas to Asia. Add to that the growing sense of unfairness in the world as the US is yet again seen to be a unilateralist nation that does not consider the consequences of its actions on the rest of the world.

While the Federal Government decision of tariffs on imported steel is meant for protecting the domestic industry, the move will destroy the competitive position in the home markets. Domestic players will become non-competitive in comparison to offshore manufacturers. It will also lead to thousands of people losing their jobs at other manufacturing companies. The tariffs on imported steel would simply mean that the American consumer pays a higher price for steel products. And, one cannot rule out the possibility of shift in consumers' preference (especially from major users like auto companies) to substitute products like plastic and aluminum.

Around the globe, the steel industry's problem is the huge amount of excess steel capacity. US-based steel analysts feel that the rest of the world's solution has been to force the US out of business by shipping enormous volumes of low-priced imports in violation of international rules. The president Bush needs to negotiate serious reductions in this excess capacity. A stiff tariff will allow steel manufacturers the breathing room to reinvest and restructure while providing the President the leverage to negotiate a long-term fix with the US' trading partners. However, instead of protecting the ailing domestic steel industry, the right business sense for the US would be that it imports steel from places where it is available chiefly. ■

N Janardhan Rao, Team Analyst

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INDUSTRY

Indian Railways

Restructuring is the key

Indian Railways occupies a special position in the socio-economic life of Indians. It is now facing acute problems in its financials and implementing rigorous reforms has become imperative to revive it.

Indian Railways one of the biggest rail networks in the world with more than 1,07,360 track kilometers, is at a crucial juncture today. Through its vast transportation network it has integrated markets and people across the length and breadth of the country. Particularly in times of war and calamities, it has risen to the occasion and become one of the foremost institutions in India. Despite all these vital contributions over decades, it is high time that the concerned authorities decide on the future survival strategies of the Railways.

Though the institution has been contributing to the economic growth of the nation, its own economies are in jeopardy today. With decreasing support from the exchequer, declining freight business and high competition from the road transportation network, stagnant revenues, low productivity, increasing staff and pension costs, and operating costs as high as 98.5 percent, the financial position of INDIAN RAILWAYS clearly indicates that it is on the deathbed.

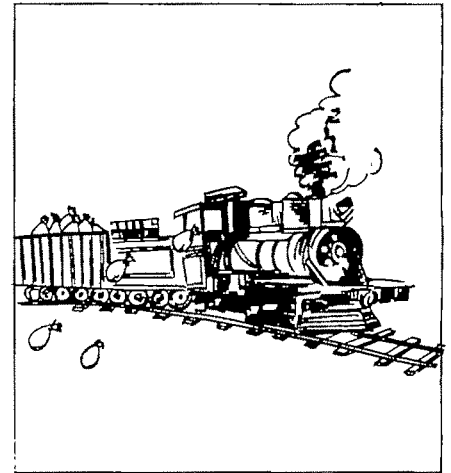
Against this backdrop, few apparent questions arise. What are the major reasons that have led to this precarious state? What is to be done to make INDIAN RAILWAYS a commercially viable entity in the future? What are the possible alternatives and what are the repercussions of these alternatives on its economic growth and employees? Though the answers to these questions may seem easy to answer, it is a difficult task considering the complexity of operations.

On the wrong track

Like the rich heritage of Indian Railways, the list of reasons for its financial distress

is also elaborate. Since its inception, Indian Railways has been fulfilling its social obligations successfully. Moreover, the increased pressure to carry out these social obligations has never been equally backed by increase in funding. According to Indian Railways sources, Indian Railways' annual social obligation is around Rs. 4,000 crore but it receives only Rs. 800 crore as compensation. In spite of this, Indian Railways continues to fulfill its social obligations like a faithful servant of the public. This has resulted in the formulation of inappropriate pricing mechanism where the emphasis is more on subsidizing lower class passenger services. It was felt that the subsidies extended to the passengers could be compensated by the increase in freight charges and higher-class passenger service charges. According to the report of the Comptroller and Auditor General (CAG) of India, between 1992-93 and 1999-2000, Railways incurred a loss of Rs. 10,000 crore on transportation of essential commodities below cost, on providing passenger and other coaching services, and for the operation of uneconomic branches.

Globally, it is the freight business that contributes more to the revenues rather than the passenger services. In fact, 70 percent of the revenues generated globally by Railways are directly attributable to freight business. In India, only 13 percent of revenue is contributed by passenger service and 87 percent by the freight business. Indian Railways has over time ignored the most profitable business of freight and is facing the consequences. Concentrating on the 13 percent instead of the 87 percent, Indian Railways has focused more on fulfilling its social obligations. As a result, its market share in



freight business came down from 87 percent in 1958-60 to less than 35 percent in 1999-2000. Globally, both in developed and developing countries, the ratio of passenger km charge to a freight tonne km charge is about 3:1 but in case of Indian Railways, this ratio is just 1:3.

Another major reason for the current situation of Indian Railways is the economic reforms. Reforms have subjected Indian Railways to a great deal of external pressure. As a result of the economic reforms accompanied by trade and traffic reductions, the call for Railways was to become more competitive. However, with trade barriers being removed steadily, more and more companies have become cost conscious. With Railways extending cross subsidies, many of the corporates have opted for road transportation to cope with the increased freight charges. During the last decade, the proportion of the total production of commodities transported by rail has come down drastically. The annual growth rate as measured by the net tonne kilometers, which stood at 5.33 percent during 1984-91, has come down to 1.86 percent during 1992-99. A significant fall in the profitable segment has had its obvious impact on the financials.

With Railways extending cross subsidies, many of the corporates have opted for road transportation to cope with the increased freight charges

Another major reason for the poor financial position of Indian Railways is high rate of investments in non-remunerative projects. Indian Railways has been investing heavily on some projects where the returns both in the short and long run are not high enough. The adoption of unigauge project, which involved huge investments during the 1990s has been pointed out to be particularly harmful to the financials of Indian Railways. Investments in electrification have also been excessive compared to the requirements of traffic. Add to this the additional financial stress due to time and cost overruns. During the last decade, myriad new lines have been sanctioned which have later been found to be unviable. Railways had already committed funds to the tune of Rs. 3000 crore on these unviable projects and requires another Rs. 40,000 crore to complete them. Majority of the lines sanctioned were to gain political mileage. Although the growth of actual investments in these new lines has been small, this has diverted vital engineering and managerial resources to a significant extent.

Indian Railways has also been confronted by rising employee costs coupled with poor productivity. Though the Indian Railways may boast of being the largest employer in India with more than 15 lakh employees, several departments of the sector suffer from disguised unemployment (i.e., where the marginal productivity of the laborer is zero). Staff costs account for more than 50 percent of the revenues generated and this has further increased with the implementation of the pay commission recommendations. Together with low (or zero) productivity levels, the huge workforce is proving to be burdensome for the sector. And if one adds the pension outgo the figures change radically. As compared to the pension outgo of 3.4 paise to each rupee earned in 1981-82, it has increased to 10.5 paise to each rupee in 1998-99.

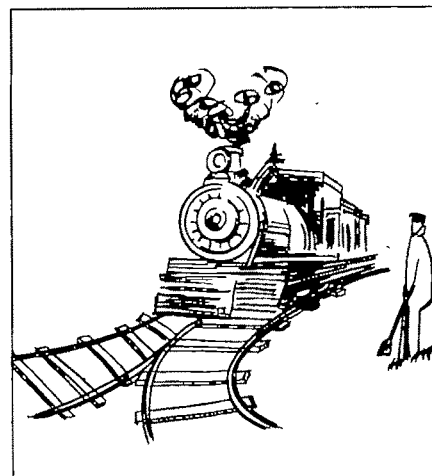
As a result of the strain on the financial resources the proportion of expenditure on repairs and maintenance has come down. In the last ten years, the arrears in track renewals have grown from 3,548 km to over 11,211 km. Further, Indian Railways, for the first time in the last 17 years, has failed to pay dividends to the Government which amounts to around Rs. 2,500 crore. In order to meet the funds constraint, as a result of decreasing budgetary support, Railways has raised

huge funds from the market directly at a higher rate. According to the CAG report, high average cost of borrowing at 12 percent during the financial year 2000-01 is one of the primary reasons for worsening of its finances. While for other sectors of the economy the interest rates are below 11 percent, it has remained unchanged since 1997 for Railways. The report also pointed out that there was a negative flow of funds by Rs. 544.62 crore to general revenues from Railways in the fiscal 2000-01, which points out deteriorating financial position of Railways. Indian Railways' inability to invest adequately and to provide efficient and cost-effective services has raised questions about its future. To restore the pride of the organization, it is imperative that it reorganizes itself and brings itself back on the track of growth.

Prescriptions for cure

Though the financials of Indian Railways appear grim, there is still scope for providing some curatives. As the Railway Minister Nitesh Kumar said, "A right definition of the problem means that 90 percent of the problem is solved. There are several prescriptions, and surgery needs to be resorted to only when all other options fail." To diagnose and identify the problem confronted by the Railways, the Railway Minister has constituted a committee under the stewardship of Dr. Rakesh Mohan, economic advisor in the Prime Minister's Office. The committee after a detailed study of the functioning of Indian Railways has come out with a number of recommendations. According to the committee, if the recommendations are implemented in the right sense, then it may not be long before we see Indian Railways back on the track of prosperity.

The committee has called for reforming the Railways immediately. Crucial among the recommendations of the committee is the gradual corporatization of Railways, thereby decreasing Government control. The committee claims that if Railways is corporatized and made to run on a commercial basis, the situation is bound to resolve. The ability of Railways to accelerate the growth rate of its revenues from both freight and passenger traffic is central to the success of any effort to restructure the organization and to finance its indispensable investments in future. The committee pointed out that the passenger fares are set with clear political considerations in mind. The



committee has asked the Indian Railways to do away with the subsidy in passenger fares and has asked for an increase of 10 percent in passenger fares over the next five to ten years.

Also, due importance must be placed with respect to freight transportation. In order to enhance market share in freight transportation, Indian Railways should adopt a combination of tariff reduction and quality enhancement. At the same time, it should try to improve its operational efficiency. To cope with increased competition from other transportation networks, Indian Railways requires a significant change in its strategy towards freight business. Today, road operators extend a credit facility of 60 days whereas Railways demands an advance payment. It should also extend the credit facility. At the same time it should try to bring down the freight charges to global levels. Today, the freight charges are highest among the rail networks in the world. Together with improved operational efficiency and reducing delays in transportation, Indian Railways can regain its lost market share. According to the Rakesh Mohan Committee (RMC), an annual growth of seven percent can be achieved if Indian Railways focuses more on freight business. This can easily generate higher revenues with its existing network.

Almost unanimously, various committees constituted so far have emphasized on reducing the high operating costs. The operating cost of 98.5 percent is too high for any business or industry. In fact, the Parliament Standing Committee has stressed for more urgent reforms in line with the blueprint drawn up by RMC. The RMC has recommended that a major restructuring is required to

INDIAN RAILWAYS

achieve the objective of commercializing Indian Railways and making its management autonomous. It has also recommended the creation of an Indian Railway Corporation at first, and to regulate its activities, an Indian Rail Regulatory Authority (IRRA) similar to the Telephone Regulatory Authority of India for Telecommunications should be set up. Once this is done, it will be empowered to decide tariffs based on commercial considerations. While the committee upheld the role of Railways as a provider of mass transportation, it emphasized that the commercial aspects can no longer be ignored. This requires definking of the cost of social and other obligations being borne by the organization from its commercial operations.

In a major shift in infrastructure development, the Parliamentary Standing Committee has recommended that the necessary infrastructure development should be fully funded by the Government as in the case of roads, airports, and ports. This means that the development of infrastructure will be taken care of by the Government and operational aspects will be taken care of by the Railways. Towards the use of infrastructure, Railways will pay the Government some taxes. This recommendation if approved and implemented will also help the Government to encourage private participation in Railways.

In future, one can see multiple transporters and multiple organizations taking advantage of the Government funded and developed infrastructure.

With respect to the ongoing projects, the Railways should aim at prioritizing them and use the available resources based on priority and viability. Most of the projects are being funded by high cost external borrowings. There is no point in commissioning new projects with negative or zero rates of returns just to fulfil social obligations or political wills. In the railway budget of 2000-01, eight new projects with a negative rate of return of Rs. 713 crore were initiated just to fulfill certain political ambitions. It is time that Railways divorced such kind of practices and commissioned only those projects that possess the potential for good average rate of return on investment. It is high time that Railways tries to improve

its efficiency by pruning the number of yards, sheds, depots and offices and augmenting capacities on saturated high density corridors. Earlier committees, including the RMC, have asked the Railways for better utilization of land and other idle assets of the Railways to increase the productivity levels. Once the productivity levels rise, it can reduce the massive workforce in some areas with no repercussions on the functioning. Since the non-core businesses do not have the long-term potential of generating revenues, Railways should exit from all such activities. Concentration on freight business and enhancing the passenger services will help it to revive the situation. Also, the RMC has recommended privatization of its production units and workshops spread across the country. Though the railway ministers have expressed reluctance to privatization, it may not be long before they will be forced to privatize the production units and workshops if the present situation continues.

In future, one can see multiple transporters and multiple organizations taking advantage of the Government funded and developed infrastructure

The RMC, considering the various alternatives, identified strategic high-growth scenario, which will boost the financials and transform Railways into a commercially viable entity. For this to be achieved, it has asked the Government to provide funds to the tune of Rs. 70,000 crore in the next five years. It has also mooted a \$1 bn multilateral funding with 30 percent Government participation. The committee has worked out a capital structure, which aims to reduce the debt burden to the tune of over Rs. 6000 crore. All these recommendations, though not new, are being emphasized again by the committee. Similar recommendations came from the World Bank in 1994 when Railways approached the former for funding. The recommendations of the committees constituted so far, have all indicated towards improving efficiency and to do away with the cross subsidy approach. Though the latest budget did not announce any decisions regarding the reforms agenda for Railways, the need of the hour demands concrete reforms and restructuring of Railways.

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Act now or never

Though various committees have recommended the reorganization of Indian Railways, people associated with

Railways have expressed serious concerns. Particular concerns were expressed regarding the recommendations of the RMC, which recommended corporatization of Indian Railways. The major opposition is targeted against the privatization of Railway production units and workshops. According to the unions, this will lead to higher costs of products and consequently the service charges. Also exiting from related services like catering and maintenance of Railways, will incur additional costs both to passengers and Railways. Privatization of some of the commercial activities will lead to serious erosion of revenues and will lead to increase in various service charges. Though opposition to reforms is common in a country like India, Government should act in the better interest of the organization.

For the medicine to work, it is important that political parties are kept at a distance from Railways. The corporatization of Indian Railways has been suggested solely to achieve this. Consider the railway budgets presented by Mamata Banerjee: To fulfill her political ambitions, she had opted not to increase the passenger tariffs and in turn opted to increase the freight charges. This resulted in erosion of its market share and this kind of policy should no longer be encouraged. It is with respect to this aspect that RMC has recommended the setting up of IRRA to formulate tariff policies. It is still one of the few commercial organizations that have huge unmet demand. If it can use the existing infrastructure efficiently; it can radically improve its revenues with very low additional costs. Effective handling of the logistics and rolling stock available will enable the operations on commercial lines.

Learning from others

Though global experience in implementing reforms in Railways is not so encouraging, Indian Government should study the reform processes being implemented in countries like Britain, Japan and Australia to avoid pitfalls. It may not be possible for Indian Railways to emulate a global agenda owing to differences in demographics and nature of operations. In the developed countries, freight business is the core for Railways since the people there depend more on road and air modes of transport rather than rail. This attitude helped the global railways to concentrate more on freight business from the beginning. However,

CII's 11-point agenda for Indian Railways

1. **Freight charges:** Freight rates on the Indian Railways are among the highest in the world due to heavy subsidization in transport of essential commodities below cost level, passenger and other coaching services and uneconomical branch lines. Freight rates have been increased in every budget, which has hurt the competitiveness of the Indian economy.
 - The freight rates should reflect the cost of operations plus profit margin. Freight charges should be on the basis of actual weight carried.
 - Phase out cross subsidization.
 - Reduce freight prices during off season.
2. Other issues which need to be addressed to increase the share of freight traffic by rail include:
 - Redesigning freight wagons
 - Reducing speed differential between goods and passenger train.
3. **"Own Your Wagon Scheme":** Interest in the "own your wagon scheme" has declined because of discriminatory excise duty policy followed by the railways.
4. **Cost of siding:** Presently, the capital cost of siding is borne by the private sector and the only customer is the railways. The cost of siding should be shared by the private sector and the Indian Railways.
5. **Credit terms:** Road transportation payments are on a 60 days credit basis while Railways charge advance payments for freight. The Railways should also extend credit terms for freight charges, on par with the road transport so as to increase its share of freight traffic.
6. **Settlement of claims:** Provide for a single window system for settlement of all freight claims at the zonal level.
7. **Right-sizing the Indian Railways:** There is a need to right-size the Railway staff strength and increase customer satisfaction by making Indian Railways commercially viable.
8. **Corporatization of production units:** The Railways should corporatize its production units and later convert them into joint ventures with international suppliers to ensure competitiveness and the induction of the state-of-the-art technology.
9. **Safety measures:** In view of the increasing incidence of accidents in the recent past, there is an imminent need to improve safety measures by strengthening the accident investigation process and introduce a system of accountability and penalties for non-performance.
10. **Restructuring the Railways:** There is a need to divide Indian Railways into two separate arms, one responsible for Infrastructure development and maintenance and the other for operation of railway services.
11. **Railway facilities:** There is a need to improve the facilities of the Railways by:
 - Stepping up electrification of railway tracks so as to reduce costs
 - Providing greater port connectivity to encourage private investment and also to help growth of foreign trade
 - Leasing out railway stations and terminals to private sector for operation and maintenance
 - Use excess railway station land for market/office areas to generate revenue
 - Introduce build, own, and operate warehouses
 - Encourage private sector participation in Railway telecom system
 - Increase private sector participation in catering and touring services
 - Encourage private sector participation in gauge conversion, R&D, locomotive leasing, maintenance of information kiosks, cleaning, sanitation conveniences, bedrolls, bookings, security, public announcements, LCD display boards on time sharing basis, etc.

Source www.cionline.org

in a country like India where the population depends more on Railways, it is important that Railways gives due importance to passenger service business but not definitely at the cost of freight. So the solution to the present problem should be our own.

The Confederation of Indian Industry (CII) has also come out with a

11-point agenda for reforming the activities in Railways (see box: CII's 11-Point agenda) The reading on the wall is clear. If Railways has to attain financial viability, significant organizational changes will have to be resorted to and a new investment program should be launched to achieve high traffic growth. If at all the intention of the government is

to make Indian Railways a commercially viable entity by the turn of this decade, it has to seriously act now without further delay so that it is able to gear up to face future challenges. ■

Y Chandra Sekhar, Team Analyst

Reference # 1-2002-05-11



BY INVITATION

Indian Railways

Reality strikes

Indian Railways is in a watershed period in its history today and therefore drastic action needs to be taken in a number of areas to make this august organization the country's pride once again, says KK Nohria, President, The Associated Chambers of Commerce and Industry of India.

Indian Railways over the past decade has fallen into a vicious cycle of under investment, misallocation of scarce resources, increasing indebtedness, poor customer service and rapidly deteriorating economics. The overwhelming sentiment of The Associated Chambers of Commerce and Industry of India (ASSOCHAM) is that time has run out. Action is overdue. The imperative is to get started fast on a program of restructuring and reform.

Unfortunately, successive railway ministers have not paid too much attention on this aspect. On the other hand, none of the finance ministers have shown interest in the restructuring of Indian Railways. The inability of the Central exchequer to meet with the requirement of funds for Indian Railways could well be understandable from its own none-too-happy fiscal condition where the abnormal increases in its non-plan expenditure has left it with limited funds to spare for Indian Railways. Indian Railways is passing through a bad phase.

The ASSOCHAM strongly feels that the Government should bring it back to health. Increasing internal resource generation, rationalizing fares and freight, scrapping of unviable projects; support of funds for accelerated completion of remunerative projects and catching up with renewal and replacement work would nurse Indian Railways back to health. Indian Railways also requires a new vision.

The loss of market share in the profitable freight business, lack of flexibility in pricing, high cost of internally sourced products and services together

with investments in unremunerative projects have meant that the rate of growth in revenues has been outstripped by the rate of increase in costs, particularly in the last five years. These problems have essentially resulted from the wrong organizational structure of Indian Railways which devalues accountability at every level.

Excess workforce and declining productivity

Rising employee costs, poor productivity and declining budgetary support have compounded the problem. Staff costs, which account for about 50 percent of the costs have been growing the fastest. This percentage is likely to increase even faster with the implementation of the recommendations of the Fifth Pay Commission. If Indian Railways is to become a truly modern transportation system offering services that could face up to the emerging competition, the issue of an accelerated reduction in manpower has to be addressed without delay.

In any set of financial projections, a substantial net reduction in employee strength (at least 20 percent of the total) has to be provided for.

Retention of current strength would rule out any upturn in Indian Railways' performance, even in a high traffic growth scenario. Going by the conclusions of a diagnostic study on this problem carried out by RITES for the Railway

Board, the excess manpower could be more than 25 percent of the total. On a very conservative basis, therefore, a reduction of 20 percent of the present overall strength should be targeted over the next five to seven years.



This will require, apart from reductions through normal retirement the spinning off of ancillary activities and also a well-designed VRS scheme to be implemented early, in phases.

Indian Railways is passing through very hard time. It is true that the Fifth Pay Commission has placed an enormous burden on our resources.

Reduction in the sanctioned manpower strength will remain a priority area. If focus is brought on these areas, the reduction in expenditure may be quite substantial. Unfortunately while it is known that Indian Railways suffers from excess of manpower, on the other hand Indian Railways spends around Rs. 20 crore every year on payment of overtime to the staff.

The relatively low levels of employee productivity in the Indian Railway compound the problems of having a large workforce. As compared with the increase in real wages (average per railway employee) of 108 percent the increase in average productivity measured in terms of output in "Traffic Units" over the period 1981-82 to 1998-9 works out to only 82 percent. The disparity would be still more adverse if

The relatively low levels of employee productivity in the Indian Railways compound the problems of having a large workforce

the component of pensioners' benefits is added to the average staff costs. Pension outgo accounted for 10.5 paise out of every rupee earned by Indian Railways in 1998-99—a steep increase as compared to 1981-82 when it was just 3.4 paise to each railway rupee.

The root of the financial problem confronting Indian Railways is therefore found in the lack of adequate productivity increases that are commensurate with the real wage increases over time. The proportion of expenditure on repairs and maintenance has been declining steadily over the years. The strain on the Indian Railways's resources has also prevented adequate investment in track renewals and other safety related areas.

Vulnerable economies

This is another consequence of the unguage project. Consequently, the arrears of track renewals have grown from 3,548 km to 11,211 km over the last 10 years. Though the overall number of accidents and the number per million train kilometers have shown a declining trend, the absolute numbers are still high, with scope for improvement.

These tendencies became accentuated in the 1990s and the economics of Indian Railways are now extremely vulnerable. For the first time in 17 years, Indian Railways was not able to pay a dividend last year to the Government on its past investment due to its financial crisis. Its ability to invest adequately in providing efficient and cost competitive services in the future is seriously in question.

Thus Indian Railways is in a watershed period in its history today and therefore drastic action needs to be taken in a number of areas to make this august organization the country's pride once again.

At the various recent meetings the ASSOCHAM has stressed the need of modernization and expansion of Indian Railways' capacity to serve the emerging needs of a growing economy. This will require substantial investment on a regular basis for the foreseeable future. With the prospect of getting substantial free or subsidized resources from the Government being unlikely, new investment will have to be financed on a commercial basis. This is the challenge facing the Indian Railways.

Tapering freight traffic

The ability of Indian Railways to accelerate the growth rate of its revenues from both freight and passenger traffic is central to the success of any effort to restructure the organization and to finance the necessary investments. All the new investment and organizational restructuring that is envisaged will be of little use if the demand for railway services does not increase apace.

One of the major reasons for the deterioration of the organization's financial condition has been a steady decline in the growth rate of freight traffic in recent years. The growth rates of passenger traffic, in contrast, have been fairly healthy, and there is a significant increase in the share of revenues being realized from the higher classes of passenger services. Despite this trend, however, an overwhelming proportion of passenger revenues is still being raised from the lower classes.

Passenger fares, especially for the lower classes, are set with clear political considerations in mind, which almost inevitably leads to subsidization. Some of this is made up by inflating upper class fares, but the potential for fully compensating for the subsidy for the lower classes from this source has been limited. To maintain some control over Indian Railways' financial deficit, the burden of cross-subsidization inevitably falls on freight traffic.

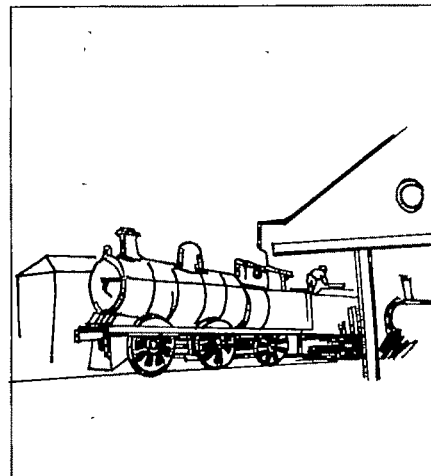
Indian Railways has been steadily losing its market share of freight to road largely because it has not been able to compete on prices.

Competitive modes of transport

Looking to the future, the changing structure of production in the economy in the next decade may

further erode the competitive position of the railways. Manufacturing activity, which is relatively more transport-intensive than services particularly with respect to bulk transportation, appears to be peaking at somewhat less than 30 percent of GDP. In India, the service sector is already by far the dominant sector, accounting for about 48 percent of GDP and also appears to be the fastest growing.

The implication of this pattern is that every increase in GDP will require faster



bulk transport services. Indian Railways will have to compete even harder with other modes in order to sustain its traffic volumes, let alone accelerate growth. Thus a significant change is needed in Indian Railways' strategy towards its freight services.

International trade has increased and will continue to increase in its importance relative to GDP. This means that transportation services will become increasingly integrated, with road, rail and sea striving to become a part of a seamless chain of goods movement. To exploit the potential in the non-bulk segment, mere pricing will not be sufficient. Indian Railways can compete for this traffic only if it offers an attractive total logistics package.

If Indian Railways takes steps to recover its market share through a combination of tariff re-balancing and quality enhancement measures, and to increase its share of the transportation of other commodities, a growth rate of seven percent per year or more over the next decade does not appear to be an infeasible objective. A medium annual growth rate of five percent for freight traffic can be achieved without major organizational changes provided the physical capacity is made available. However, there is potential for increasing this rate further through a strategy that has pricing and operational components in addition to providing physical capacity.

To bring Indian Railways back on its track it has to adopt the strategy of high growth. The principal strategy for achieving a very high growth lies in aiming at a growth rate of goods traffic that has not been reached in the past. The railways have to undertake structural changes to make possible the

One of the major reasons for the deterioration of the organization's financial condition has been a steady decline in the growth rate of freight traffic in recent years

simultaneous high growth of freight and passenger traffic possible, as outlined in Rakesh Mohan Committee report.

Our financial projection exercises show that for Indian Railways to be financially viable as a commercial organization, incremental improvements in traffic growth will not be adequate. For Indian Railways to survive over the next 20 years and beyond, it has to adopt a strategic perspective where it rekindles high growth in both the passenger and freight segments. It is imperative that Indian Railways achieves this strategic growth. Although this scenario is ambitious in its goals, it provides an attainable target for Indian Railways with respect to growth in revenues.

Freight is the key profit earner for Indian Railways. The long-term strategy of increasing freight rates too frequently over the Eighth Plan to protect railway profitability has been counterproductive, driving freight customers to other modes of transport, or even resulting in structural changes in their industries to reduce transportation costs. There is an urgent need for a new viable, long-term strategy to profitably grow the freight business.

In order to survive, the railways have to lower bulk freight rates and regain market share lost to trucks. It is disheartening to note that it costs more to send goods from Delhi to Mumbai than from Mumbai to London. Because of uncompetitive freight rates thousands of trucks bring coal from Bihar to Punjab.

Freight costs can no longer absorb the cost of excess labor, and if labor is rationalized, studies show that freight rates could be halved and the railways would still make a profit on freight. But to regain freight primacy they will need new container terminals with new operators, to raise the speed of freight trains, improve communications and signaling, and link its processes through information technology. Most importantly, they have to change their monopolistic take-it-or-leave-it attitude to the customer. The threat of early retirement will help here.

Cost of social responsibilities

With respect to the Indian Railways' movement of passengers the central

problem is that more than 90 percent of traffic is in the low-price segments. The key challenge to the Indian Railways is to maintain its obligations on the lower price services, while at the same time increase both capacity (through investment) and utilization (through innovative pricing and other marketing instruments) of the upper classes. The revenue potential from the upper classes needs to be exploited to the maximum extent. The prognosis here is quite optimistic in view of the ongoing changes in income distribution towards higher incomes in the country. Indian Railways has already responded to these ongoing changes in the demand pattern for passenger services by introducing new classes of services such as Shatabdi Express, Second Class AC 2 tier, Chair Car services and new trains such as Shatabdi Express.

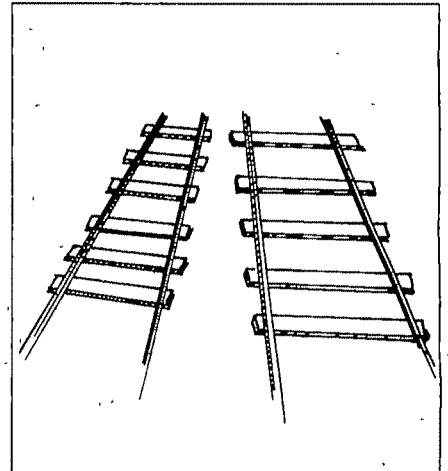
Future tracks

ASSOCHAM feels that continued innovation should be the mantra of Indian Railways to achieve high growth rate. The attainment of financial health will necessitate both higher growth in traffic as well as tariff rebalancing. Indian Railways has little option but to rebalance passenger tariffs in a manner consistent with the elasticities of demand for the various classes.

From the point of view of investment strategy, the most undesirable feature of the annual budget exercise is the very short-term focus it imparts to all investment initiatives. The priority for Indian Railways is to invest in debottlenecking points of congestion in the network (particularly on the saturated arterial networks of the Golden Quadrilateral linking Delhi, Kolkata, Chennai and Mumbai).

Instead of debottlenecking, Indian Railways is being forced against its wishes to invest in initiatives that make matters worse not better. About half the Capital Fund has been absorbed in gauge conversion which has produced no discernible performance improvement. New lines have absorbed 20-30 percent of borrowed capital, only to increase Indian Railways reach into areas where there is little or no traffic.

Unfortunately, plans for the future are worse still. Indian Railways does not currently have a vision. Indian Railways



does have a five-year plan but this is not a vision; it is not even a strategy. It is merely a worthy exercise to assemble the requirements of the businesses as they exist today. Here it is important to highlight that the total payment made by the Railways to the various SEBs during the last five years is around Rs. 4000 crore every year. This is indeed a huge burden on the already overstretched Railway's finances, but is unfortunate that where railways acted in haste to create a catering corporation it never paid attention to address the issue of power.

ASSOCHAM feels that in power sector railways not only can promote private investment with the guarantee of power purchase agreement with private power producers but can also reduce its operational cost. Railways should also plan to draw a road map to increase resources internally. ASSOCHAM feels that railways should come out with a plan to use its huge idle properties commercially. An essential criterion for success in developing a meaningful vision is that it is both owned and understood by the organization and also syndicated and accepted by all those directly involved in transforming vision into reality.

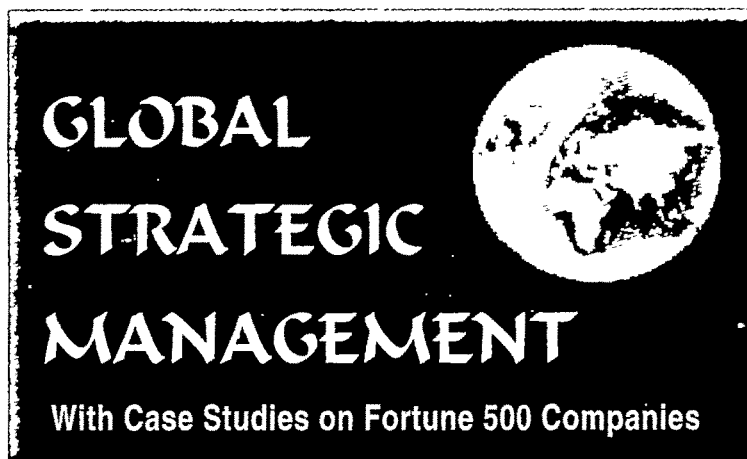
Indian Railways needs to critically examine its current portfolio and decide which of its many businesses are core and which should be spun off. Indian Railways should engage only those businesses directly related to its core activity of rail-based logistics and passenger transport. ■

Indian Railways needs to critically examine its current portfolio and decide which of its many businesses are core and which should be spun off

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CORPORATE STRATEGY

Big Businesses

Survival conundrum

While experts are still grappling with reasons for Enron's collapse, the premature deaths of several so-called giant-sized organizations like Global Crossing in the US, Kirch Media in Germany, NTT in Japan, and those of UTL, IDBL, and IFCI in our own backyard, raise serious concerns about size.

"Companies don't exist forever.. some survive for long periods of time, but immortality is the exception rather than the rule."

—David Nedler, management thinker and Ex-Professor, HBS

When on June 21, 2001, the US-based Corning Inc. celebrated its founding day, it was its 150th anniversary. Given the background of collapsing companies the world over, Corning Inc.'s celebration is a rare occurrence. Since 1917, when Bertie Charles Forbes formed his first list of the one hundred largest American companies, till 1987 when *Forbes* republished the original "Forbes 100" list, 61 companies from the original list had ceased to exist. Among the remaining 39, only General Electric has been able to sustain its growth while its stock outperformed the benchmark index, S&P 500. Unfortunately, the list of corporate survivors is not a long one.

Can one forget the shocking demise of Enron, which was once an icon of corporate America? While experts are still grappling with reasons for Enron's collapse, the premature deaths of several giant-sized organizations like Global Crossing in the US, Kirch Media in Germany, NTT in Japan and those of UTL, IDBL, and IFCI in our own backyard raise serious concerns about size. Why is it that a company, which grows to a monstrous size, just cannot hold itself for long, before crashing to ignominious lows. But then what is it that makes companies like Corning and GE not only survive but retain their leadership status as well?

Big businesses' big problems

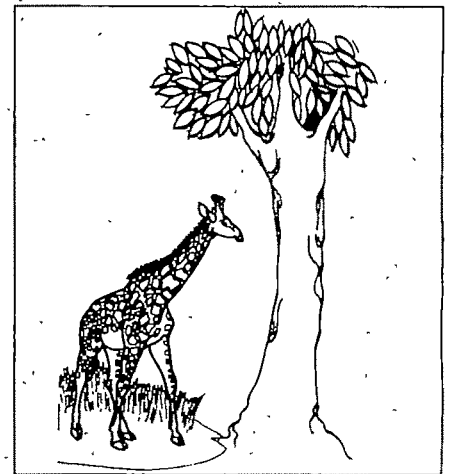
Though opinions can vary on whether size of the company matters, it is true that behind most of these corporate crashes, size has played an important role as the colossus but extremely complex balance sheets of these corporations suggest. Karl Sveiby, Principal, Sveiby Knowledge

Associates, a consulting firm, and Professor in Knowledge Management at the Swedish School of Economics and Business Administration in Helsinki, Sweden, comments, "To manage a company means solving problems, managing a big company means solving BIG problems."

So what are these big problems? A major issue large companies face today is how to gain an edge over these nimble-footed small competitors. Another but equally important issue before these large corporations is how to deal with rapid technological change. The companies now also have to deal with a greater challenge, that is, how to deal with the changing customers' preferences and their tastes. The advent of Internet has added to the changing dynamics of the businesses, with speed becoming an important factor in any businesses.

However, that is not to say that all big businesses are getting overwhelmed by the scale of these rapid changes or are unable to manage through changes. Examples like GE, Microsoft, Corning and Wal-Mart are there to prove that managing through change is not too overwhelming a task. It is to be noted here that small start-ups also face similar problems. How do they meet with such challenges? Perhaps their small size, which helps them absorb the shock and recover from that quickly, is an advantage, which their big counterparts don't enjoy. Concurring with that Sveiby opines, "Research generally draws the conclusion that, on an average, small companies are more efficient and create more value per employee than big companies. This tends to be true in most industries."

In spite of change being a constant for both the Goliaths as well as the Davids of the business world, big companies like Corning have managed such unprecedented growth year after year.



The answer lies in the fact that these companies got their strategy right and they were dispassionate about those businesses, which did not make much economic sense.

Noted management philosopher Michael Porter has described this survival conundrum a result of flawed ideas about what is called strategy. According to him, the idea about strategy in most cases has been misconstrued either for producing best quality products at the lowest cost or market consolidation. This flawed idea had managers believe that strategy at best is about either becoming a low-cost producer or attain formidable size through consolidation. This could be attributed mainly to three major developments. First, during the 1970s and 1980s, managers tried to work on strategy but soon got disenchanted as they tried implementing it. Or, at worst, got overwhelmed by the difficulties. Second, and at the same time, the rising popularity of Japanese management practices which put emphasis on improvement in quality as well as reducing production costs on a consistent basis made executives believe that strategy is not so important, but how to produce top quality products at lesser costs

compared to your competitors and then to cut your costs relentlessly is. Third, the emergence of the notion that in a world where change is the only constant, it is not important to have a strategy.

Porter uses the word 'drumbeat' to highlight the point about how people went overboard to suggest that business was about change and speed and being dynamic and reinventing oneself; that things were moving so fast, one couldn't afford to pause. If you had a strategy, it was rigid and inflexible. And it was outdated by the time you produced it. Such notions reflected a deeply flawed view of competition and that view has become well entrenched.

But do the examples of sheer indifference towards the importance of strategy mean that successful, though big, companies like Microsoft, Corning or Wal-Mart did not have a strategy. Not really.

It's all about choices

The changing business landscape has led to the blurring of the boundary between what constitutes strategy and what comprises operational effectiveness. So how is strategy different from operational effectiveness? Michael Porter distinguishes strategy from operational effectiveness in the sense that while strategy is about making choices, trade-offs, importantly about deliberately choosing to be different, operational effectiveness is about things that you really shouldn't have to make choices on, that is it is about what's good for everybody and about what every business should be doing.

The Japanese management practices such as Just-In-Time, Total Quality Management, and Business Process Re-engineering etc., have all focused on the nitty-gritty of getting a company to be more effective. Such practices were accepted in many markets across the globe owing to the incredible competitiveness of Japanese companies. However, of late, the obsession with such practices is becoming more of a problem for Japanese companies. This effectively underlines that more than anything else it is strategy that can create a sustainable advantage for companies. As Porter advocates: Strategy is about choices. You can't be all things to all people.

Set your limits

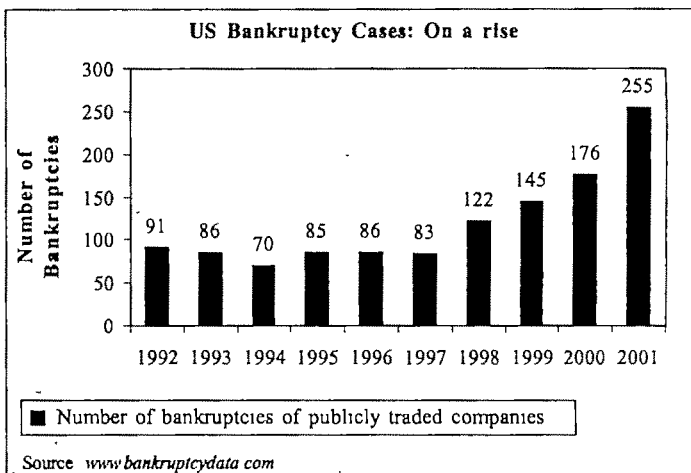
Porter suggests that the essence of strategy is that one must set limits on what he or she is trying to achieve. A

company without any strategy would be willing to try anything. And if it is the same as what all the other competitors are doing then it is unlikely that one could become successful. Hence, one major danger here is that if a company is betting that it could deliver the same kind of products at a less cost, then effectively one is betting on the incompetence of one's competitors—and this is what one does when he or she competes on operational effectiveness. The focus on operational effectiveness tends to create a mutually destructive form of competition (is Dell listening?). In other words, if everyone is trying to get to the same place, then, almost inevitably, it leads to customers choosing on price. This in turn, leads to a price crash, and that is what is being seen in the market in recent times, especially after Internet became a possibility.

Moore's law is quite visible in the case of semiconductor industry where prices have collapsed like never before over the last several years even though the storage capacity has risen several folds. But has that meant Intel "Inside" lost its way? No. In fact, the giant has become even more active and has also benefitted because of that development. The key lies in looking for that opportunity for strategic differences. As Porter says a much more positive kind of competition could emerge if managers thought about strategy in the right way.

Keep debt monster in check

A common link between most of these bankruptcy cases has been the problem of huge debts that these companies accumulated during their hay days. These companies borrowed heavily to either continue growing organically or through inorganic means like mergers and acquisitions. Enron has been one of the worst examples of a corporate going haywire by venturing into so many unrelated areas by borrowing recklessly, and, the worst of all by not showing the



same on its balance sheet. The company hid its colossus debt by floating hundreds of special purpose entities, thereby avoiding consolidating all the debts which it could be held liable for.

Companies like Global Crossing and WorldCom are today bankruptcy cases because of several ill-conceived acquisition deals funded through heavy borrowings at exorbitant interest rates. Now the question is how they were able to do so when their actions were not so rational. Capitalizing on the buoyancy of the markets during 1990s, companies were able to create illusions about the growth potential of such acquisitions. They were able to do so also because of the skyrocketing valuations markets accorded to their stocks. This made their task easier in garnering huge sums of money. But isn't it a bit surprising that the lenders ignored the possibility that the party might come to such an abrupt end? Perhaps the blame lies in what the Fed Chief Alan Greenspan calls "irrational exuberance".

Once the technology bubble burst and stock prices of the so-called new economy companies came down, the fallacies of such mindless borrowings by companies started to come to the fore. All those mind boggling growth numbers and synergy benefits that companies had promised while going for M&As are turning out to be baseless. The lesson? Be prudent.

Threat of disruptive technology—is it for real?

How has the so-called disruptive technology changed the way business is being done? Also, has this disruptive technology led to the demise of several corporate behemoths like Enron, Global

BIG BUSINESSES

Crossing, and Kmart? "No, those are examples of the frailty of the existing accounting system and the never-ending greed and ego drive of mankind," asserts Sveiby.

Agreed. But then one could ask whether Enron had got its strategy right? The company's strategy was to emerge as a major energy trading company, without getting into manufacturing which hurts profits. But their investments in setting up a power project in India (Dabhol Power Corporation), or in water assets in UK do suggest that its strategy had major flaws.

Porter says that the underlying principles of strategy are enduring, regardless of technology or the pace of change. Take for example the Internet. Whether you are on the Net or not, your profitability is still determined by the structure of your industry. If there are no barriers to entry, if customers have all the power, and if rivalry is based on price, then the Net does not matter—you will not be very profitable. In case of energy trading business of Enron, this was clearly visible. As the US energy markets became more deregulated it saw several players entering the fray. And because each one of them was competing on the pricing platform, ruthless undercutting by virtually all the players saw Enron's bottom line bleeding.

The right approach, therefore, could be a sound strategy with a right goal. According to Porter, if you don't start with a goal of superior profitability and seek it pretty directly, you will quickly be led to actions that will undermine strategy. And, also, any other goal such as becoming big or achieving faster growth or to become a technology leader without having that goal of superior profitability in mind is bound to hit hurdles.

Another aspect about strategy that one must take care of is continuity. It is the basic value a company aims to deliver to its customers, so strategy is something which cannot be constantly reinvented. Any repositioning could simply confuse both the company as well as its customers.

The case of South West Airlines (SWA) can articulate this aspect clearly. While SWA is still a profit-making company today, several airlines have been hit badly by the worldwide economic recession worsened further by the 9/11 WTC attacks. The secret of SWA lies in its strategy of remaining profitable by serving to price-sensitive travelers who want short and frequently offered flights



"...growth in itself is a sign of success, so managers try to grow at all cost, growth hides mistakes and creates a dynamic climate."

*Karl Sveiby, Principal,
Sveiby Knowledge Associates,
a consulting firm, and Professor in
Knowledge Management at the
Swedish School of Economics and
Business Administration in Helsinki,
Sweden*

without much service. This clarity has seen the company operating only on the commercially viable routes. The company also does not offer any in-flight meals as it thinks it would not be in line with its strategy of what it wants to deliver to its customers and would not make it any different from rivals like United Airlines who offer such services.

Solving the change riddle

One thing, which haunts a manager today, is the constantly changing change. Setting a strategy has, therefore, become a bit complex. Before the technology revolution began to affect life, one could take enough time to set strategy, define the target audience and the organizational objective and then get set for the journey on those paths. Now the time to take decisions has shrunk and one has to grapple with a whirlpool of information pouring in on a continuous basis. So simply framing a strategy is not going to take a company anywhere unless the management is able to constantly absorb all the information and is able to improve its ability to deliver.

Companies not only have to maintain this continuity of change but would also have to continuously improve their armory of capabilities to deliver just like SWA, which has aggressively been assimilating new ideas to deliver on its strategy. Today, the company does many things differently than it did 30 years ago but it is still essentially serving the same customers who have essentially the same needs. The lesson from SWA is that a manager has to understand that if he or she does not have a direction and lacks something distinctive to offer, it will be difficult to

slug it out in the marketplace for long. And, the ability to balance the continuity of strategic direction and continuous improvement in how one does things would hold the key to future success.

Another good example here would be Wal-Mart, the retail major from USA. Today, it is shining at the top in the Fortune 500 ranking, beating names like Exxon-Mobil, Citibank and GE. The company, as the *Economist* wrote recently, has come to account for 60 percent of America's retail sales with no other global retailer coming close to it as far as sales is concerned. The company's strategy of offering "everyday low prices" to its customers is now becoming the new icon of American business.

On the homefront

If you look at the domestic market few names do pop up like Hindustan Lever Limited and Reliance Industries. Reliance's strategy of looking to facilitate supply rather than create demand is the key behind the group's stupendous success and this is what makes it the first Indian private sector company to make it to the Fortune 500 list this year. But this has not happened overnight. Reliance did have its fair share of early hiccups. At one point of time, the company had invested heavily in the manufacturing of textiles. The entry barriers to the industry were low, and hence price undercutting was rampant. And, so brand building had hardly any relevance. Reliance shifted its corporate attention at the right time by refusing to gamble on the prospect that the fabric market would recover.

The company's polypropylene business is another example. The installed capacity for polypropylene in the country when Reliance conceived of the project was two lakh tonnes per annum (tpa)

against an existing domestic supply of 1.5 lakh tpa. Reliance commissioned its plant with 3.5 lakh tpa capacity. This might have sounded a crazy idea to anyone at that time. However, the rapid growth in the consumption which spiraled to roughly 5.75 lakh tpa from a mere 2.95 lakh tpa in 1994-95 has proved that the company was right on track as far as its strategy was concerned.

HLL's strategy over the years has remained the same: To serve every single home in the country. And the company has consistently come out with innovative ideas to penetrate the big Indian bazaar. Its micro-credit scheme, which aimed to reach rural consumers, is a novel plan well in line with its strategy. The company has over the years been trying to shuffle its product basket and has come out with innovative ideas to maintain its leadership status. A good example is the Softy project by which it has been able to bring out the ice cream at a lower price level of Rs. 5 a piece, similar to what the roadside vendor offers, but with a better quality.

In all these examples what is noticeable is the fact that these big companies not only worked out their strategies well but continuously kept on working on innovative ideas. They were able to sense new opportunities and were dispassionate about getting rid of unproductive, unsustainable businesses (restructuring initiatives at AV Birla and Tata Group are good examples).

Today, Corning is the world's leading communication company because they had this ability to exit a market space where they did not see opportunities. They no more make light bulbs and are mostly out of the picture-tube business and the sunglasses business. They have got rid of the cookware business too.

What were the strategic reasons behind such a continuous shift in focus? The answer lies in the approach of the management, which once clearly underlined their focus saying, "This is a business that no longer capitalizes on our strengths. We are a company engaged in science, invention, and processes, usually in things we hope will change the world. That's not what this business is about."

Don't fear the size

Ironically, the idea that big is beautiful has not gone down well with too many people, though the list of such protestors itself is getting bigger. If it was Judge Jackson in the case of Microsoft who gave the world's most powerful IT company

many sleepless nights over his view to break it down, the party of GE-Honeywell merger was jeopardized by Minto of European Union. And, more recently, the angry old man from Hewlett family, Walter Hewlett is raising a flag against the proposed giant-size merger (worth \$19 bn) between the two behemoths of IT industry, HP and Compaq.

But opposition to big businesses is not new. Way back in early 1940s, the US Supreme Court Justice Louis D Brandeis raised concerns about big businesses in contemporary corporate America.

Are such players protests justifiable? Perhaps not. Size is no symbol of aggression. Microsoft became a big company but this has also benefitted the American economy, creating thousands of millionaires and enriching millions of investors. In case of Standard Oil, due credit goes to its sheer size which helped bring down the retail price of kerosene by about 70 percent thereby helping almost every household in America. While Ford brought the price of an automobile within the reach of many families.

Though it is true that size could be menacing and big businesses could abuse their monopoly at times, as witnessed in the case of Microsoft and Standard Oil, the competition, it is believed, could take care of any monopolists. This was proved in the case of Ford whose legacy was successfully challenged by GM. HP and Compaq have been challenged by Dell. Even in India, people are no more driving the Ambassador, thanks to Maruti and a slew of other carmakers, and viewers now do not have to wait for a week to watch their favorite *Chitrahaar*, thanks to the entry of Zee, Star and others. As the industrial history shows, competition has always ensured that no monopoly lasts for long. Sometimes as experts say a monopoly is good for the society as it raises the general performance for the industry. One could say, for every big business, there will always be an Amul emerging to challenge the status quo.

The Largest Public Company Bankruptcies in US—2001

Company	Bankruptcy Date	Total Assets Pre-Bankruptcy (\$ mn)
Enron Corp	12/3/2001	\$63,300.00
Pacific Gas and Electric Co.	4/6/2001	\$21,470.00
FINOVA Group, Inc., (The)	3/7/2001	\$14,050.30
Reliance Group Holdings, Inc	6/12/2001	\$12,598.05
Federal-Mogul Corp	10/1/2001	\$10,150.00
Comdisco, Inc	7/16/2001	\$8,754.00
ANC Rental Corp	11/13/2001	\$6,349.50
360Networks (USA), Inc.	6/28/2001	\$5,596.00
Winstar Communications, Inc.	4/18/2001	\$4,975.44
PSINet, Inc.	5/31/2001	\$4,492.30
Bethlehem Steel Corp.	10/15/2001	\$4,347.00
Laidlaw, Inc	6/28/2001	\$4,000.01
Exodus Communications, Inc	9/26/2001	\$3,894.40
USG Corp	6/25/2001	\$3,214.00
Sunbeam Corp.	2/6/2001	\$3,132.34
Global TeleSystems, Inc.	11/14/2001	\$2,833.80
Hayes Lemmerz International	12/5/2001	\$2,811.60
W.R. Grace & Company	4/2/2001	\$2,509.06
Warnaco Group, Inc	6/11/2001	\$2,372.71
Arch Wireless, Inc	12/6/2001	\$2,309.60

Source: www.bankruptcydata.com

Bigness—let the quest continue

It is true that though the large size of the business is not the only responsible factor for the collapse of companies like Enron, Kmart etc., it is one of the many factors responsible for their collapses.

So do the recent corporate collapses mean death of big businesses? Sveiby opines, "Growth in itself is a sign of success, so managers try to grow at all costs; growth hides mistakes and creates a dynamic climate. Another reason is that managers always try to reduce risks and being employed by a small company feels arguably more risky than being employed by a big." He adds, "Other reasons range from the strive for monopolistic super profits (Microsoft), founders cashing in and selling out (Lotus), to capital intensity (Big Oil), to individual super CEOs with super egos (GE) or just plain ego (Enron)." Recent collapses in Germany like Kirch Media, the free-TV and rights-trading business of the Kirch Group, one of the largest business conglomerates of Germany, and the great hurry shown by other business groups like BSKYB of Rupert Murdoch suggest that the zeal to grow bigger and bigger is not going to die down just because a few Enrons or Kirch Media have fallen by wayside. In fact it would not be an exaggeration to say that for every fallen prey, there will be a dozen vultures like BSKYB seeking to grow big. ■

Amit Singh Sisodiya, Team Analyst

Reference # 1-2002-05-13

INDUSTRY

Internet Telephony

Net talk

Internet telephony which has existed for some time in India, has been legalized only now. Judging from its low cost benefits, it is party time for consumers and hard work for operators who have to clear the quality glitches.

April 1, 2002 marks the legal entry of Internet telephony into India and also the end of state monopoly on international long distance telephony. For the cost conscious consumers, it is a cheaper option for making long distance calls though the clarity may not be as good as basic telephony.

Internet telephony integrates voice and data communications. It routes the communication services—voice, facsimile and voice-messaging applications—through the Internet, rather than through the Public Switched Telephone Network (PSTN). When an Internet call is made, the analog voice signal is converted to digital format and compression or translation of the signal takes place into Internet Protocol (IP) packets for transmission over the Internet. This is termed as Voice Over Internet Protocol (VOIP), which is the next revolution in telecom. It marks the next phase of technology evolution and ushers in an era of convergence. Despite its enormous potential, VOIP as a technology still has some way to go before it emerges as an effective substitute for telephone lines.

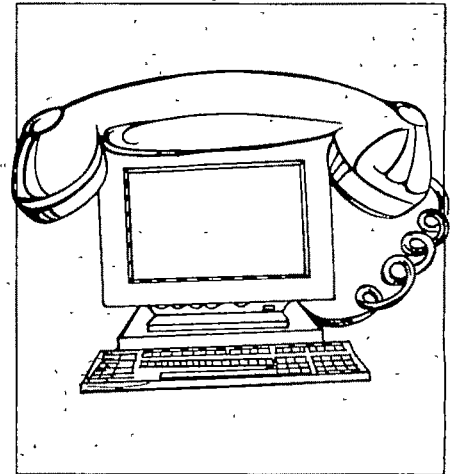
IP telephony means a gamut of possibilities. Voice mail can be managed from PCs and dialing can take place from Microsoft Outlook. Other VOIP benefits may include new applications like Web-enabled call centers, remote telecommuting, "follow-me" services where one phone number is accessed

worldwide via the Net, and unified messaging.

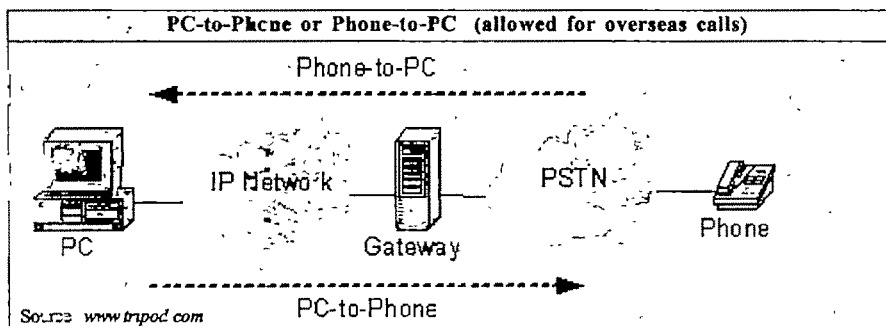
Cheaper alternative

With Internet telephony, a one-minute call to the US, which costs around Rs. 40 now would cost only Rs. 8. It could be even lower for people accessing the Net through a cable or Digital Subscriber Line (DSL) with flat monthly access charges. The calls are cheaper than the PSTN calls because the Net access is at local call rates. Conventional phone systems convert voice to an electrical signal transmitted over a series of lines and switches. The conversation blocks the entire line for the duration of this call thereby denying connection of other calls. Internet telephony, on the other hand, converts voice into packets of digital data, which travel over the public Internet or privately owned business networks that use the same network protocol, IP. Unlike conventional calls, these voice packets share the line with other digitized packets of data. As they use network capacity more efficiently, IP calls are cheaper.

According to Telecom Regulatory Authority of India (TRAI) recommendations, Internet telephony services would include PC-to-PC connections within and outside India, PC-to-Phone in India as well as abroad along with IP based H.323/Session Initiation Protocols (SIP) terminals. There would be two tariffs—one for toll quality and another for less than toll quality.



IP telephony is cheap but so is its quality. The quality depends upon the speed of the Net and once the optic fiber networks of private operators are in place, quality of bandwidth will improve. But then, VOIP operations will continue to run on data networks, which are of a lower grade than telephone networks handling voice. In fact, Cisco and Juniper estimate that it will be about three years before state-of-the-art data networks, that can carry seamless voice, match up to the voice networks set up by Motorola or Ericsson. However, once bandwidth and the quality of data networks improve, the potential is enormous. In China, for example, there is a boom in VOIP, and VOIP cash cards are used as wedding gifts. Madanmohan Rao, an independent consultant and writer based in Bangalore, and co-author of the handbook *The Internet Economy of India 2001* says, "Contrary to popular misconceptions, the quality of VOIP service has actually improved dramatically, and major carriers of the world have been steadily incorporating IP networks. IP telephony is already making a big splash across the border in China. Launched in May 1999, China Unicom had the world's largest VOIP network implementation in place in



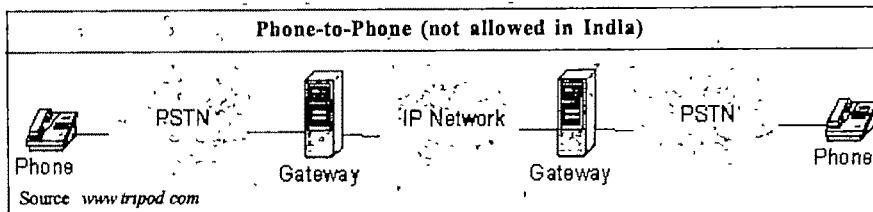
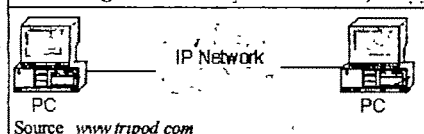
2001, accounting for usage of over 2.5 million minutes a day, 10 million calling cards, and revenues of US\$ 200,000 a day." India has improved the technology at hand and once other players are allowed the quality problems would be sorted out. IP technology would also mature over time just as cellular technology did a few years ago. And as it matures its costs may go down as a result of which customers can be treated to lower prices.

Effect on ISPs

ISPs, which have been allowed to offer Internet telephony services, are jubilant but have to overcome some crucial hurdles. They face competition from freely downloadable software like Buddyphone, Dialpad or PC2phone, which allow one to make telephone calls over the Internet. PC owners would rather use these, as they will have to pay only for the connectivity and not the Internet telephony tariff set by ISPs. But considering the low levels of PC penetration in the country, the cyber cafés are the ones, which would drive mass-market growth. Rustom Irani, Chief Technology Officer at Sify agrees, "In the Indian market where price performance ratios are important, Internet telephony will be looked at as a cheaper alternative to toll quality international voice. Technology is a barrier when it comes to the cost of acquiring technology (home PCs), but this would be overcome with cyber cafés, which are public access points available to the common man."

Since any interconnection to PSTN in India is prohibited, ISPs have to limit their operations to PC-to-PC and PC-to-phone calls (overseas). ISPs are also not allowed to have media gateways in India to connect to PSTN. A lucrative segment that dial-up ISPs could hope to service is corporates operating on leased lines. PCs connected on such leased lines can connect to overseas computers by using the services of Indian ISPs. However, they may not want to do so because savings from IP telephony may not be immediate. Abandoning the existing telephone system to make IP calls, may take quite a while and it would be long before the per-minute savings overcome the installation costs.

PC-to-PC (allowed in India for countrywide long distance communication)



A similar challenge was confronted in US during IP telephony's early days there. Some vendors overcame the situation by offering bundles of advanced services instead of focusing entirely on savings. Because a VOIP system will do more than a company's phones, it is supposed to make the cost of upgrading the telephone switch (and potentially the phones themselves) easier to gulp. In its infancy, IP telephony really meant nasty-sounding connections. Today, quality has improved tremendously although after dialing, it can take anywhere from 5 to 15 seconds to actually complete a connection through the maze of Internet and local phone networks.

Then again ISPs would be under pressure from International Long Distance (ILD) operators, who might drop rates. The ISPs have to better this rate to make a profit. Kobita Desai, Senior Telecom Analyst at Gartner agrees, "Legalization of Internet telephony will indirectly put pressure on ILD operators to lower prices and to improve services. The opportunity for ISPs lies in propagating Internet telephony services through Internet kiosks and public call booths." Industry sources feel Hotmail and Yahoo, offering voice chat, may open up another round of wrangling as only ISP license holders are allowed to offer Internet telephony. Hitches apart, for ISPs, which have been witnessing tapering growth, the IP option is better than none. No wonder then that ISPs like Sify, Data Access and Net4India are geared up. Irani believes that "The Indian market is a large one and would be more comparable to China than US. Sify made available Internet telephony to its dial-up subscribers. There will be separate offering for its corporate customers which is taking shape as well." Data Access will also offer Internet telephony but does not expect the service to contribute significantly to its overall revenue. Net4India has phonewala.com for its IP telephony business.

IP globally

Worldwide, the IP market is taking off, rising from almost zero voice calls in 1997 to just over three percent of international

voice traffic (four billion minutes) in 2001. Some estimates suggest that by 2004, up to 40 percent of all international telephone traffic may be Net-based. Price and cost savings are driving the market. In countries where the telephone network is developing, Internet telephony is particularly attractive. China has gone all out to develop Internet-based services. It is less interesting for companies to do thus in countries like Germany where the phone network is already well-developed. Rao points out that according to some research reports, close to five percent of international phone-to-phone calls travel over IP networks today; more than 10 percent of calls from the US to Mexico are already traveling over the Net. Big names like Microsoft are getting on the VOIP bandwagon, too. It has enhanced the IP telephony features available in its instant messaging products. Microsoft Windows XP gives users a choice of voice-over-IP providers with whom to establish an account.

India could become the fourth-largest Net telephony market in the Asia-Pacific region by 2004, after China, Japan and South Korea. A report by global IT analyst, International Data Corporation, predicts that the Indian IP telephony market will grow at a compounded annual rate of 119 percent to reach Rs. 13,000 crore by 2005. Total legal ILD traffic in India is about three billion ILD minutes now. By 2006, about 30-40 percent of ILD calls will be routed through VOIP.

Internet telephony is changing the voice and data communications terrain across borders. Asia and India within it, is the lucrative region for the growth of IP telephony propelled by deregulation of the markets and maturing of technology. Low PC and Internet penetration are still stumbling blocks. It may so happen that IP can catapult the PC demand. Whatever be its implications, IP telephony is the future of telecom. ■

CSV Ratna, Team Analyst

Reference # 1-2002-05-14

BUSINESS ENVIRONMENT

APM

Caught on oily grounds?

The Administered Price Mechanism (APM) dismantling was expected to usher in an era of a brave new world of competitive prices, better margins and better returns. But as the Government keeps its hold on the sector, the fortunes of oil companies as well as the consumers take a hit.

News about oil embargoes sends shivers down the spines of people who are well versed with history of oil prices. The expected spurt in oil prices as Iraq announced a month long suspension of oil exports as a protest against Israel's invasion of Palestinian areas on West Bank, has made the economic forecasters grip their calculators in frenzy and work out the damage that more expensive oil might cause to a recovering economy.

On a daily basis some 16 million barrels of oil leave the Gulf through the Strait of Hormuz. That is enough to power every motor vehicle on the planet for 25 miles. The Gulf region aka Oil Producing and Exporting Countries (OPEC) accounts for 40 percent of global trade in oil. The more important statistics is that it makes for two-thirds of known deposits. Yet all those numbers come with caveats, which are surrounded by scary talks of unstable, spendthrift regimes and a lurking fundamentalist menace. Nevertheless, it is never wise to underestimate the bulwark of the oil empire. In the last 30 years, the oil prices have escalated sharply on five occasions: in 1973-74 after an Arab embargo; in 1979-80 after the Iranian revolution; in 1990 after Iraq's invasion of Kuwait; in 1999-2000 as the world economy boomed and the OPEC production quotas were cut and after the September 11, 2001 incident. On each occasion when the oil prices zoomed, the world economy went into a spin.

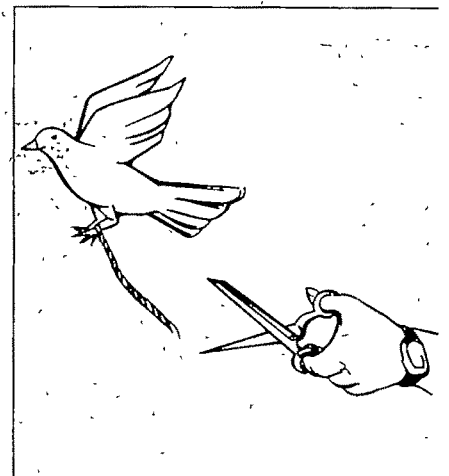
The ongoing conflict in the Middle East is intensifying and a global oil crisis is looming large on the horizon. With Iraq's announcement on April 8, 2002, of a temporary embargo on oil exports to the West, and threats from Iran and Libya to follow suit, the chances of sharply rising oil prices seem to be more. Colluding to increase the oil prices when the global

economy is showing nascent signs of revival will not be an act that would be welcomed. However, in the light of recent events, OPEC's days of glory seem to be well over. For a while in the late 1990s, it appeared as if the oil cartel could regain its old power to keep up the price of oil according to their own will. The oil price has plunged after OPEC launched a price war to force Russia to join it in making substantial production cuts. Russia, which has now replaced Saudi Arabia as the largest oil-producing nation is not playing the ball, and the oil prices could go for a roller-coaster ride. Russian cost of oil exploration and refining is close to \$10 per barrel and it can still make money with crude prices of \$15 per barrel. But the same is not true with OPEC nations, which are inefficient producers, and want a range of \$22-28 per barrel.

The oil importing countries including India are in for times that are marked by specter of changes as far as pricing of oil and related products is concerned.

APM: (Sp)oil the economy

Dr. Atmanand, Associate Professor of Economics, Management Development Institute, Gurgaon, Haryana and Editor, *VISION*, a journal of MDI, feels that the oil industry in India is the wheel of the economy and has strategic linkages with almost all other sectors. Oil imports constitute one-third of total imports of the country. An increase of \$2 in crude oil prices leads to an addition of around \$1.1 bn to India's import bill on an annualized basis, according to a research report by Morgan Stanley. The spurt in the oil prices imminent in future might lead the RBI to work for softer interest rates, as this has been a tool to counter rupee depreciation. Though the fiscal policies of the government and the sound forex reserves (now over \$54.5 bn) might help



the Government to absorb the shock of rise in oil prices for the next two to four months, a continuous increase in the oil prices will not be in the interest of a rebounding economy.

On April 1, 2002, the APM, which governed the Indian oil sector for nearly 30 years, was officially scrapped. In a deregulated system, the price is that rate, which floats with changes in global crude rates with producers' and retailers' margins added on and the government taxes slapped over that. In India the differential has been artificially maintained with petrol at about Rs. 31 per liter while the same quantity of diesel costs about Rs. 17. Internationally the two products are priced almost the same.

With every one dollar increase in crude prices, petrol should be dearer by 55 paise per liter while diesel prices should rise by 45 paise. Going by these calculations, since crude prices have moved up more than \$4 per barrel between February and March this year prices of both these products should have gone up by close to Rs. 2 per liter.

However, the Indian Government seems to be reluctant about giving its

"Is it time that the Government constitutes an independent regulatory body for the Indian oil sector. There is certainly a need for an oil sector regulator."

Ravindra P Purohit, Economic Adviser, Hindustan Construction Company

□ Do you think that if the Government keeps on falling prey to populist hijacking and is entangled in an endless game of rollbacks the Indian economy will get the much-needed spurt?

This year's budget is rather cruel to the fixed set of salaried class. And this hardship is not imposed for any lofty ideal. It is simply a substitute for the Government's inability to control its own wasteful expenditure. So if it is a rollback to put some money back into the hands of squeezed-like-sugarcane taxpayers, it is welcome. In a demand deficient economy, the least any sensible Finance Minister could do is to refrain from "tax and consume" budgets. Regarding partial rollback of LPG price-hike, it was a ridiculous surrender. LPG has become a symbolic holy cow. No one thinks and no one wants to take any pains to explain its impact on the "poor LPG users", which includes all of us. Presently, the cost of cooking gas per day works out to be around Rs. 3 to Rs. 3.50 for an average family. This is not even as much as the cost of a local bus ticket to a nearest destination or that of a half a scoop of ice cream! If the Government completely stops subsidy on LPG, a cylinder would cost about Rs. 260 to Rs. 270 depending on the location. It would still be Rs. 4 or there about for an average family per day. So what are the people protesting about? Both the Government and the opposition are equally irresponsible when it comes to populist tendency.

□ What effect will the increase in oil prices have on inflation?

A little. Depends on the magnitude of the price hike. The international prices being at a



high, scope of further increase is rather limited in the medium to long run. Even in the short-term, the scope is not very high. Let me explain. The mineral oils have a weightage of about seven percent in the Wholesale Price Index (WPI). Suppose the present international price goes up by 10 percent from \$27 to \$30 a barrel and domestic prices need to be adjusted across the board. For simplicity assume no change in the impact of government taxes. It will lead to a 0.7 percent direct increase in inflation. Taking all effects into account, total inflationary impact could be about one percent. This is a worst-case scenario.

However, as I mentioned, international oil prices being high, these are likely to go down in the medium term. When that happens, consumers will benefit. But the fact must be noted that oil products' prices will witness greater fluctuations post-APM.

□ The northward bound global crude curve has squeezed the margins of Indian marketing majors. What steps

can they take to protect their falling profits?

The long-term average of global oil price is around \$16-18 per barrel. When the oil prices veer around the median, Indian companies would surely have comfortable margins. Even for now, their guaranteed margins around 10-12 percent are quite attractive. Marketing companies now need to compete aggressively by changing their service delivery and bundling other services. A few companies have already started doing this. The high incidence of state and central taxes is another area. These companies should press with governments to lower the incidence of taxes. Above all, they have the option of increasing the price of oil products having low price elasticity.

□ How can oil companies work on brand differentiation and earn more customer loyalty in the light of dismantling of APM?

As stated, major companies have already started along these lines. However, the scope for brand differentiation is rather limited. Tie-up with credit card companies, providing other attendant services, shopping and leisure avenues etc., are essentially to this end.

□ On what lines should the Indian Government constitute a regulatory body for the oil sector?

Is it time that the Government constitutes an independent regulatory body for the Indian oil sector. There is certainly a need for an oil sector regulator. The Government has announced in this year's budget to set up a Petroleum Regulatory Board during this year. One hopes that it will be an independent body and not a refuge for retiring babus.

control away. The combined profits of three oil-marketing companies (IOC, HPCL, BPCL) will take a hit of Rs. 100 crore every month in case the international crude prices continue to rule around \$25 a barrel. This follows the government's advice to hold the price line for the next three months even after the dismantling of administered price mechanism in the petroleum sector. In case the rate of excise

duty on these products remains unchanged, the oil marketing companies will have to take the hit if they are to maintain the current price line.

Instead of letting the competition keep prices down, and find their own Mariana Trench, the obsession of the Government with regulating the prices in the oil market has become a ritual. The ministries of finance and petroleum have

opted to manipulate prices through changes in duties and taxes. The consumers are also burdened by the habit of state governments to mop up revenues by scaling up the sales tax whenever retail prices come down. In the end the consumer is left to bear the burden of artificial pricing, whether APM is there or not. Take the case of Maharashtra, which has increased the

sales tax on high speed diesel for Mumbai to a whopping 40 percent in its latest budget, making the levy the highest in the country. For petrol, the rate was increased to 34 percent. Thus the sales taxes on these products have become a milch cow and many states engage themselves in this kind of exercise. Apart from the states, the Center too has its share of levies in the form of customs and central excise, which further increase the fuel prices. Petrol attracts a 32 percent excise levy, while diesel and Aero Turbine Fuel (ATF) are taxed at 16 percent and kerosene 8 percent duty. In fact, oil levies account for 15 percent of the government's revenue.

Such incidences of high taxes have led to protests world over against the concerned governments. In countries such as France, the Government has been forced to roll-back and cut taxes to ease tension. In UK, the consumers had started a "Dump the Pump" exercise and blockaded all refineries in Europe, when oil prices spiraled increasing the pressure on consumers.

When the Government announced its intentions to partially divest its stakes in major PSUs (Public Sector Undertakings) like IBP, BPCL, and HPCL coupled with the dismantling of APM, it was considered that reforms would continue. However, the recent purchase of IBP by another PSU, Indiar. Oil Corporation (IOC) can be construed as changing money from one pocket to another and is a cause for concern.

Corporates: Bowed not broken

There is no doubt that the Indian Government's idea is hamstrung by a big flaw. It is the idea of keeping the reign in its hand that buttresses the latest transition. Corporate warriors from different strata of the oil world have expressed their concerns over the latest developments.

With the news about dismantling of APM gathering momentum, the oil companies have created a stir in the markets. However, this policy has already run into trouble, with the international crude prices moving up to \$26 a barrel in April, from the February levels of \$23 a barrel. The Government has assured the companies that if the prices go above the \$23 a barrel level, they will intervene to offset the losses that

the companies will incur. Oil market companies are already asking for intervention. They are of the view that either the prices should be totally market determined or the Government should go in for fiscal intervention. Most marketing companies are now beginning to feel the brunt of the increase in prices. Stand alone refinery companies like Reliance and MRFL will be selling products to oil market companies at import parity prices. The higher crude prices and the import parity realization adds margins to refinery companies and squeezes margins of marketing companies in case of controlled prices.

The Government should have taken into consideration the same while framing policies for dismantling the APM. Research studies show that the upward movement in the sentiment of oil prices is expected to continue. Demand is expected to grow and OPEC members also seem to be reluctant to pump more in the markets. These are the finer details that the Government should have taken into consideration while framing the APM policy.

On the brighter side, the dismantling of APM for oil companies is a shift from 12

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percent rate of return to flexible marketing margins. This will harbor better changes for oil companies, which can now look forward to better returns. The retail petroleum product is expected to change with time. The existing public sector companies are preparing to face the new entrants as the private sector companies follow

up each of their moves with utmost diligence. However, the process will be slow for the Indian "oil scene" is marked by numerous approvals and the investments required are also too high.

The new players who have qualified to enter the domain are Reliance Petroleum (RPL), Mangalore Refinery and Petrochemical (MRPL), Essar Oil, Nagarjuna Oil, ONGC, Oil India, Cairn Energy and GAIL. The Government has stipulated a Rs. 2,000 crore investment as a precondition for entering into retail marketing. It is felt that these players will first bid for the government's stake in HPCL and BPCL, before committing investments to new outlets for sale of transportation fuels.

Talks of integration of IOC, ONGC and GAIL are also in line with the global

Global Top 10 Oil Markets		
Country	Oil Consumption (Mt)	Five-year CAGR (%)
China	226.90	7.10
India	97.60	6.00
USA	897.40	2.10
Canada	82.90	1.70
South Korea	101.80	1.40
France	95.10	1.30
Italy	93.00	-0.50
Germany	129.50	-0.80
Japan	253.50	-1.10
Russian Federation	123.50	-3.30
Total world	3,503.60	1.60

Source: BP Amoco Statistical Review

trends. The big ticket mergers of the 1990s such as those between Exxon-Mobil, BP-Amoco-Arco and Total-Fina-Elf catalyzed in all cases a massive restructuring of the merged entities. The reason that is being cited for the merger of Indian oil giants is that it will create a vertically integrated company, which will be able to cater to all functions from drilling, extracting, and refining and selling petroleum products. This will provide economies of scale.

Oil companies are also realizing the need for brand differentiation and are making attempts to create an identity for themselves in order to attract the customers. The companies are also working on their packaging, which for them translates to keeping their retail outlets better. The margins could be given a boost by value additions in the form of opening of McDonald's-type food outlets, chemist shops, telephone booths and also co-branding, which has already happened with credit card companies. The corporate world is still searching for the right answers which they will find as they go along the way. Success will depend on how well they leverage their strengths.

The topic *du jour* is that the Government must realize that the oil companies are no longer its handmaidens. Moves such as the present directive to them to hold on to the existing price lines for another three months do not fit in a deregulated scenario. The consumers should also be educated on the lines of free markets. An independent regulator should also be put in place in order to set the different issues related with deregulation straight. As the perils and promises come along the way, the Government must let APM go and let the oil prices be market-determined. ■

Aparna Mehta, Team Analyst

Reference # 1-2002-05-15

Indian Stock Market Indices

To float or not to float?

The Indian bourses are debating whether to shift the index calculation methodology from market capitalization to the internationally popular free-float method.

With the visit of FTSE Chief Executive Mike Makepeace to Mumbai to attend the round table conference on free-float, the debate on whether the Bombay Stock Exchange (BSE) should adopt this methodology of index construction is gaining momentum.

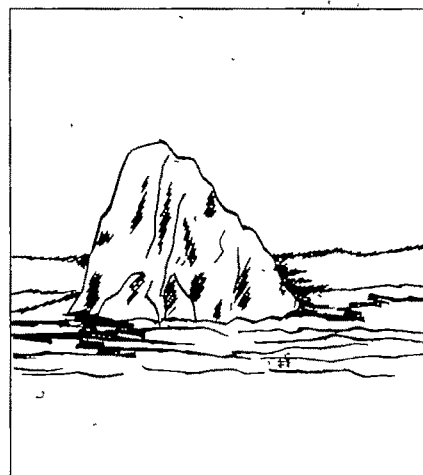
Why is the BSE thinking of this change when its indices are widely accepted by the market players? The answer is not too far to see. Globally, the concept of free-float methodology for calculating the index weights has become popular among major stock exchanges. FTSE has already adjusted all companies in its indices to the free-float from June 2001. MSCI would fully move to free-float by June 2002. Others like IBEX, AEX, BEL, DAX, CAC are seriously considering the free-float. Even in India, the free-float methodology has been used earlier in the construction of BSE-TECK, an index for technology, entertainment, communication and other knowledge-based sectors. It was launched on July 11, 2001, and was appreciated by all the market participants.

Dow Jones Indexes and Stoxx Ltd. were the first of the major index providers to move to free-float. The Dow Jones Global Titans 50 index was launched as a free-float index on June

18, 2000. The entire Dow Jones Global Index family—including the pan-European Dow Jones Stoxx indexes moved to free-float capitalization on September 18, 2000. *Analyst* (November 2000) had earlier carried an article on free-float, "Stock Market Indices—Float and Flash" when major global stock indices were readjusted for free-float.

Why free-float?

The transparent practices of the free-float methodology with ready availability and accessibility to data, the need to share the data and a strong feeling that this methodology is superior to other methods seem to have prompted global players to shift to this mode of index calculations. Mike Petronella, Managing Director, Dow Jones Indexes says, "As a modern index provider, we try to employ the best methodologies. We see ourselves as an innovator and are always looking for new trends in our industry. The time was right to make the change to free-float because the necessary ownership data was more readily accessible. Our efforts and the efforts of others for transparency of ownership data were responded to positively by those who control the data. The "democratization" of the ownership



data was the key to implementing free-float. We always considered free-float market capitalization for indexes to be superior to full market capitalization."

Free-float is essentially the percentage of shares that is freely available for purchase on the markets. Therefore, free-float excludes strategic investments in a company such as stake held by government, controlling shareholders and their families, the company's management and restricted shares due to IPO regulations or shares locked under employee stock ownership plan. Foreign ownership related limitation imposed by the Government and the company is also taken into account.

A low free-float lends itself to volatility and manipulation and rise in the price of the illiquid stocks (due to large promoter holding) which can cause the indices to move equally sharply. The volatility in the BSE Indices can be compared with those of the indices in the West where the free-float adjustment factor of most companies is near to 1. This would show that the Indian indices are more volatile. Low free-float can also give rise to price manipulation where a group of investors or even a single speculator



"We always considered free-float market capitalization for indexes to be superior to full market capitalization."

*Mike Petronella,
Managing Director,
Dow Jones Indexes*

INDIAN STOCK MARKET INDICES

can move the prices. The saga of the K-10 stocks was scripted by a single individual who could manipulate the share prices.

Therefore, basing an index purely on free-float removes this anomaly to a large extent and reflects the underlying market movement in a better way. Also, companies with a low floating stock which may be leaders in their respective industries can be included in a free-float based index whereas there may be a hesitation to include them based on market cap method.

All the market players especially the fund managers have accepted free-float. If a company in the index is closely held and has a low floating stock the fund managers would have to pay high impact cost to replicate the index. In the free-float methodology, closely held companies would have a much lower weightage and hence the impact cost would be much lower. It is also easier to replicate by passive fund managers. The index providers agree that this methodology is what the market players need. Petronella says, "The market has accepted our free-float approach very well because it is based on the needs of the marketplace. Managers who use our indexes can be confident that the weightings required in



"Companies in developed countries have a low promoter holding and hence free-float methodology would have a lower impact."

*Parag Parikh,
Chairman, Parag Parikh Advisory
Financial Services Limited, Mumbai*

their portfolios will match the shares available in the marketplace."

Float information: Crucial for success

But the success of the free-float methodology largely depends on the disclosure of the correct shareholding pattern which provides details on the number of closely held shares, shares held by different strategic partners and the shares available for the investing public. Getting this true free-float

information is difficult in the developing countries like India. But the recent efforts made by the Indian regulators like SEBI is being widely applauded. Parag Parikh, Chairman, Parag Parikh Advisory Financial Services Limited, Mumbai, says, "The recent format of disclosure mandated by SEBI is praiseworthy. The split of shareholding between promoters, persons acting in concert, institutions and public is satisfactory. However, ultimately it is up to the management of the company to segregate the shareholding in a fair way and disclose the figures appropriately. Also some amount of subjectivity can creep into the classification and in such cases it is up to the regulator to scrutinize and classify the same."

Apartment depending on the regulators, the global index providers do a lot of research investing time and resources to learn about the shareholding patterns of companies. Mike Petronella explains "Dow Jones Indexes and Stoxx Ltd. expend a great deal of effort to get correct free-float information. We have expanded our index staff in order to accurately track the free-float for the nearly 5,000 companies that make up our Dow Jones Global index family. We use several sources, including data vendors and the Internet, and we contact companies directly, if necessary to get this information."

Indian companies: Low float

Moving to the free-float methodology in India has another inherent problem. Most of the companies in India have a small free-float. The promoters in most Indian companies have a very high stake. On the other hand, in the developed world the major shareholders have a small percent of the stake. The available free-float in most American companies is above 90 percent. Parikh agrees "Companies in developed countries have a low promoter holding and hence free-float methodology would have a lower impact than in a country like India where several promoters have holdings of over 40 percent."

So would there be a change in the weightage in the BSE-30 index after adjusting for the free-float. Certainly there would be changes and the hard hit would be companies like State Bank of India, Hindustan Petrochemicals Limited and Mahanagar Telephone Nigam Limited which have substantial government holdings. Companies with high free-float would be rewarded. They would see a rise in their weights and companies with low free-float would see a drop in their weights.

There is also a scope for unintended consequence. While free-float methodology

Current Float Factors of the Stocks on DJIA			
Sl. No.	Ticker Symbol	Name	Float Factor
1	AA	Alcoa Inc	1
2	BA	Boeing Co	1
3	UTX	United Technologies Corp	1
4	GM	General Motors Corp.	0.802
5	JPM	J.P. Morgan Chase & Co	1
6	DIS	Walt Disney Co.	1
7	DD	E.I. DuPont de Nemours & Co	1
8	HWP	Hewlett-Packard Co.	0.8415
9	IBM	International Business Machines Corp.	1
10	JNJ	Johnson & Johnson	1
11	MRK	Merck & Co. Inc	1
12	AXP	American Express Co	0.8863
13	C	Citigroup Inc.	1
14	SBC	SBC Communications Inc	1
15	T	AT&T Corp	1
16	PG	Procter & Gamble Co	1
17	HON	Honeywell International Inc	1
18	GE	General Electric Co.	1
19	MMM	3M Co	1
20	CAT	Caterpillar Inc	1
21	XOM	Exxon Mobil Corp.	1
22	HD	Home Depot Inc.	1
23	IP	International Paper Co.	1
24	EK	Eastman Kodak Co	1
25	MCD	McDonald's Corp	1
26	WMT	Wal-Mart Stores Inc	0.6176
27	INTC	Intel Corp	1
28	KO	Coca-Cola Co	0.9195
29	MSFT	Microsoft Corp.	0.8628
30	MO	Philip Morris Inc	1

Source: Dow Jones Indexes

"The shareholding pattern disclosures in India are no worse than in other developing countries."

Manoj Vaish, Deputy Executive Director, The Stock Exchange (BSE), Mumbai

□ Has BSE decided to go in for free-float methodology or is it thinking on those lines? If yes, what is the time-frame?

BSE had already made a beginning as far as implementing free-float methodology is concerned. BSE launched the country's first free-float index "BSE-TECK Index" last year, which is based on free-float methodology. The issue at hand now is whether the same methodology can be applied to sensx or not. For this BSE wants to generate a consensus through debate amongst the various market participants before taking any decision in this regard.

□ What has prompted BSE to think on these lines?

BSE considers that free-float methodology is a better way of reflecting the true market movements as the weight of a scrip in a free-float index is based on the free-float market capitalization and not based on the total market capitalization as is the case with the currently followed practice of "full-market capitalization" weighted indices. Free-float market capitalization reflects the investable market capitalization which is much less than the total particularly in the case of closely held companies like Wipro, etc.

□ What has been the experience globally?

Globally all the major index providers have shifted to the free-float methodology. Since June 2001, the entire range of FTSE indices are fully free-float adjusted to reflect

availability of stock in the market available for public investment. MSCI has decided to implement free-float methodology to all its indices in two phases. The first phase was implemented on November 30, 2001 and the last phase would be implemented on May 31, 2002. Outside of Australia and the US, S&P's indices around the world have been "free-float" adjusted since inception. All Dow Jones Indices are free-float adjusted except the Dow Jones Industrial Average which is price weighted. The NASDAQ-100 Index is calculated using a modified capitalization-weighted methodology.

□ Shareholding pattern filed with the exchanges plays a crucial role in making free-float methodology a success. Often it is said that it is very difficult to assess the true shareholding pattern given the information filed at least in developing countries like India. What are the special efforts made to identify and scrutinize the shareholding pattern?

The shareholding pattern disclosures in India are no worse than in other developing countries. In fact, around 1,800 companies have been filing the shareholding pattern to the BSE on a quarterly basis.

BSE along with SEBI and other stock exchanges has devised a format which adequately helps in discerning promoter and non-promoter holding distribution of a company. This requirement has been made a part of the Listing Agreement of the Exchange.

However, discerning true free-float from this format is not an easy task. For this purpose, BSE is considering drafting of a revised format specially to meet the needs of calculating free-float based indices.

□ What is the reason behind the growing popularity of the free-float methodology world over?

World over, index investing (also called passive investing) is much higher than active investing. While passive investing in India constitutes less than 0.1 percent of the total market capitalization, in developed markets like that of the US the same is at 10 percent. Index funds which track benchmark indices generally want to replicate the index in toto. However, due to high promoter holdings in case of closely held companies, they are not able to do so, leading to higher impact cost and tracking error. It is here that the free-float based benchmark indices help them in better tracking and replication as the weight of scrips in the index is based on their float available in the market, which helps them in investing in those scrips.

This is particularly true in the case of international investing where FIIs generally track (invest in) benchmark indices in order to get an exposure to a country. If foreign ownership limits in respect of index companies is not considered in calculating the benchmark index, foreign investors will not be able to find sufficient stock available in the market to invest so as to perfectly track the index.

rewards companies with higher investible shares, companies which provide high shareholder value but have less free-float would be marginalized.

There is also a concern from some corners that in the event of shifting the methodology, historical data relating to the sensx movement may become irrelevant. But BSE could learn from the global experience. In order to have continuity of data stock exchanges the world over have provided backward calculation adjusting for the free-float.

What ever be the concerns and challenges in shifting to the free-float method, the BSE has started thinking of

converting to free-float calculation very seriously. With the popularity and acceptance of free-float growing by the day, it would be very difficult for BSE not to buck the trend. Commenting on the reasons behind the popularity, Mike Petronella says "This is the correct way to weight indexes. There is broad interest in investing strategies tied to indexes. This is particularly true in the US, and increasingly so in Europe. There is a strong need and demand for a consistent and accurate means of measuring stock markets. I believe that free-float weighting is the best and meaningful method. A stock index is intended to

measure that which is available to the investor."

However, the move to free-float would not be sudden. The process usually takes time. All the market players have to be taken into confidence and the fund managers given sufficient time to adjust for the new weights. The major index provider like Dow Jones Indexes and Stoxx Ltd. had discussed the issue of free-float with the marketplace for a number of years before implementing it. ■

D Satish, Team Analyst

Reference # 1-2002-05-16

BOOK SUMMARY

Riding the Bull, Beating the Bear

Market Timing for the Long-Term Investor

Investors flock the stock market with the intention of earning higher returns than anywhere else. While the temptation drives many to the stock markets it is only a few who establish a track record of unblemished success in beating the stock market time and again. The book unveils a new process, called the 'Y' process, which could help investors achieve their cherished goal of maximizing returns while keeping the costs at minimum.

Part I: For the novice investor

Before embarking on the journey of making wealth there are six simple tenets that have to be kept in mind by novice investors. They are: Set specific goals, develop the habit of investing, diversify your investments, invest within your risk tolerance, understand the time value of money and understand the meaning of opportunity cost. Seemingly common sense tenets, these simple principles help in clarifying investment strategies that the investor should adopt to meet his specific needs.

Investment goal setting, the objective for which one is saving is an intensely personal affair, be it for the child's college tuition, or providing for one's retirement, the purpose is different from one person to another and it is only that specific person who can

define his goals properly. The first step in setting the financial goals is to understand the present state of affairs properly. What is the position now, in terms of assets, liabilities, is the starting point.

Investing is not a one-time affair. To gain the maximum returns in investment, develop the habit of putting money into an account. Small sums of money put in regularly would go a long way in future. Another possibility is to start small and gradually increasing the monthly investment amount as

another important aspect that investors have to bear in mind while evaluating investment alternatives. Success with one's money often lies in being able to identify the winning side of the time value equation "The time value of money works against you if you are the one waiting to collect the money and for you if you are the one who has to pay."

Another important aspect that is often overlooked by investors is the concept of opportunity cost. Before grabbing any investment opportunity an investor has to be sure as to what is the opportunity cost of the chosen investment opportunity.

Bonds

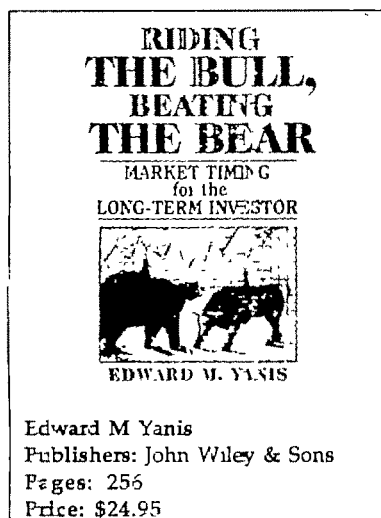
For any investor, preservation of capital is the first rule of investing. While many investors consider investing in risk-free government bonds as the approach to conservative preservation, one has to keep in mind that even these risk-free government bonds come at a price. The real returns from stocks and bonds can be calculated only after returns are adjusted to inflation. Inflation erodes the purchasing power of the dollar. Bonds are good investment options in the portfolio of investments for the following reasons:

- Economic forces that depress stock prices in the early stages of a recession tend to boost bond prices
- Bonds can generate impressive profits from capital gains when the original bonds are bought at a discount and suddenly the prime rate is reduced significantly. The result is an immediate jump in the value of the bonds.
- Bonds can provide a predictable stream of relatively high income that can be used for living expenses or for funding other parts of your investment plan.

Though bonds are relatively risk-free there are certain risk reducing steps that can be followed by a bond investor. The first one relates to the timing of the purchase of bonds. The ideal time to buy bonds is when interest rates have stabilized at a relatively high level or when they seem about to head down. It is a good idea to invest in bonds with maturities of three to five years. These bonds are prone to less volatility. Rather than putting all the money in one kind of bond it is a good investment strategy to diversify among the bonds invested. Rating by reputed agencies form an important factor in determining which bond to put one's funds in. A rating lower than 'A' should eliminate the bond as an investment option.

Mutual funds

Mutual funds rank among the most flexible and potentially advantageous investment for the beginning investor. The advantages are obvious: Professional management, lower costs,



one's income increases. Making investing a regular habit is the best chance to acquire wealth.

It would be acknowledged without argument that a prudent investor spreads his investments. Diversification is an important strategy when it comes to investments. An investor has to be aware of his risk tolerance or risk bearing capacity. Moreover investment alternatives should be evaluated based on the returns generated in comparison with the risks undertaken. A prudent risk is determined by the goals, age, income and other resources, current and future financial obligations of the investor in question. It is safe for an investor to remain within his/her risk zone and comfort level. Time value of money is

automatic diversification, flexibility in selection, ease of purchase and sale, etc. In addition, the attractions of a mutual fund are small minimums and fractional purchases, automatic reinvestment of earnings and shareholder services. While the returns and advantages are tempting there are certain costs that have to be kept in mind while evaluating mutual funds. The costs incurred in investing through a mutual fund include, loads, fees and expenses. Mutual funds impose a sales charge or load on investors who buy new shares. For example, a fund charges a load of 8.5 percent. If an investor is putting in \$10,000, the amount that is invested will be $\$10,000 - \$850 = \$9150$.

When investors sell shares of a fund, they may incur another charge, a redemption fee. The general trend is that redemption fees scales down with the passage of time. There are other costs such as transaction costs, portfolio management fees and operating expenses. All these expenses have to be considered while evaluating the return generated by a mutual fund. Mutual funds come with various types, sizes, different strategies and investment objectives. Money market funds are one option and since 1970 have an unblemished track record of safety, liquidity and competitive yields. Though money funds are not insured the possibility of a money fund failing is almost non-existent.

Index funds are yet another popular investment avenue. Their attraction being the index they emulate and the reduced operating expenses. Index funds hold roughly the same securities in the same relative amounts all the time, so there is no need for a manager. Instead, these funds are passively managed, which means that the securities are bought and held, rarely traded. This in essence reduces the costs incurred in fund management. A true index fund should have low costs besides demonstrating good success in following the index.

Part II: For the intermediate investor

Majority of the intermediate investors are long-term, buy and hold investors with diversified portfolios. The goal of most of these investors is to build wealth that would support a comfortable retirement. The study of the psychology of investing forms beneficial insights as to the pitfalls that can be and have to be avoided. No matter how smart an investor thinks he is or how smart he actually is, he must have made mistakes in the stock market that cost him thousands of dollars. The culprits: A series of mental blind spots or knee-jerk reactions. Investors generally listen to poor advice; succumb to euphoria, fear, anxiety, overconfidence, and any number of human failures.

The most common psychological pitfalls in investing are overconfidence, fear of loss, and deep regret over errors besides overlooking opportunity cost, etc. A calm rational approach would go a long way in minimizing the impact of these psychological factors. Another major psychological factor is the inability to stick with an investment style and strategy. Though an investor might have formulated a clear plan of investment as per his investment objectives, it is rare that he sticks to it. The dynamics of the stock market do not allow an investor to rest assured. If the stock is not performing as per expectations there is an urge to sell out. Stock market gyrations can be instrumental in driving investors into frenzy. One way to avoid this pitfall is to write on a piece of paper, the investment strategy, along with the reasons for adopting such an investment strategy. A look at the logic thought out in quieter times would minimize the chances of going beyond the chosen investment strategy

About the Author

Edward M Yanis is the Chairman and CEO of Yanis Financial Services, Inc., which publishes a weekly market commentary newsletter. Yanis is the developer of the Y-Process®, a revolutionary stock market model that forecasts crucial market turns, enabling investors to reduce risk and enhance returns.



Listening to one adviser and not diversifying are other sure shot recipes to loss-making investments in the market. Investing in stock market is an activity aimed at earning returns. The more objective the assessment, the better the returns, for loss of objectivity often leads to loss of money. For instance, it is never a sound choice to feel married to one's investments. Decision to buy or sell should be driven by the returns earned. Another major problem is the attitude to buy a stock because it is cheap. If a stock is bought because it is cheap, the loss would be 100 percent since the company could go bankrupt soon. A stock that is cheap is cheap because it deserves to be and its chances of going up are little. As already emphasized there is no free lunch. While calculating the returns one has to give due attention to costs and taxes.

Funds can be classified into a number of categories based on various criteria such as the amount of money invested by them, the kind of scrips in which they invest their money, the kind of fund management (active or passive), etc. In addition to the comparison with the benchmark index, it is necessary to constantly evaluate the investment in the mutual fund to know if the time has come to sell it or hold it. The following watch list should put the investment in the mutual fund on a "green alert", meaning that the particular fund should be under close scrutiny so as to be able to sell in case the situation calls for. Early indicators are when the performance starts to lag, the fund manager leaves, the fund changes its investment criteria, the fund closes to new investors, the characteristics of the fund's portfolio of investments changes and finally when the investors' objectives itself have changed.

Part III: Sophisticated investors and the use of the Y-Process

Y-Process is an active management strategy that instructs you on how to assess risk and make trading decisions. The process is aimed at preserving capital during market downturns and is focused on determining the time to re-enter the market after the worst is over to enhance total returns.

The Y-Process was developed using statistical mathematical analysis of 71 years of S&P's 500 index data. The process signals the investor when to enter the market and when to sell the market. This investment strategy gets the investor out of the market in time to avoid most of the bear market and gets him back into the market to take advantage of most of the recovery. The consequences of this timing strategy are a) to reduce the severity of the drop of the investor's stock portfolio; b) to put the investor in treasury bills while he is waiting to return to the recovering market; and c) to shorten the recovery time to the investor's portfolio's value before the bear attacked.

The Y-Process does help investors in beating the bear, but what is a "bear market". Officially a bear market is when the stock market index losses 20 percent or more from its previous high. A stock market index normally goes through three phases before being officially declared a bear market. Phase one is a

RIDING THE BULL, BEATING THE BEAR

routine decline, a decline of five percent or greater, phase two is a moderate correction, a decline of 10 percent or greater; and the third phase of a severe correction, a decline of 15 percent or greater. It is only in rare circumstances the market slices right through these phases, such as the assassination of a president. The recovery from such events is rapid. Normal bear markets typically start with a routine decline and the chance of a routine decline turning into a bear market has been only nine percent whereas approximately 25 percent of moderate corrections become bear markets and almost 60 percent of severe corrections typically become bear markets.

Traditionally bear market has been defined as a 20 percent or more drop from the previous peak of the DJIA (Dow Jones Industrial Average). However, the DJIA consists of 30 blue chip companies and might not be representative of the 7,800 companies trading in the stock market. It would be better if the definition of the bear market were based on the S&P 500. The percentage drop from the previous high is indicative of the bear market. The period to recover from the bear's bite has varied greatly with the longest being after the Great Fall of 1929 when it took 25.2 years for the market to recover its peak.

The unprecedented growth in 1990s coupled with the relative toothlessness of the recent bear markets have made bullishness a cult among investors. Investors were lulled by more than a decade of extraordinary 19 percent average annual returns in the market. Most young investors expected that stocks would always outperform other investments. A strong psychological shift in investor sentiment from bullish to bearish is required to shift from a bull phase to a bear phase. This shift comes when stock prices go down, and stay there. From the view of investor psychology, bearish sentiment must make a significant foothold. This foothold is a function of the severity of the bear's bite (percent of decline to the bottom) and retacement (the time it takes to return to the last peak).

Investing efficiently

Trading too often is a mistake committed by many investors. To maximize returns, an investor should have entry and exit thresholds and not consider stock market investing as a game. Believing that after the pain comes the gain is yet another mistake committed by investors during a bear phase. To stay with the falling market with the idea that it is bound to regain would prove to be a folly if what follows happens to be long lean years.

In a declining market sticking with a loser or putting more money into the stock market because the stocks are trading at dismal prices could prove to be very expensive. In a declining market, the focus should be on restricting losses. Investing too conservatively or taking unnecessary risks could prove to be wrong decisions in a bear market. The best way out is to diversify investments. Another piece of advice is not to listen to market prognosticators, since they do not have an iota of idea of the recovery they talk of. An investor would be well advised if he does not believe in the comments made by brokers and financial planners during a bear run.

There are three popular schools of strategic investing—fundamental analysis, technical analysis and efficient markets. Each school approaches the questions of security selection and market timing differently. Fundamental analysis falls into two groups, growth investing and value investing. Value fundamentalists analyze companies, industries and the economic and market environments to identify stocks that are undervalued at their current market prices. Growth fundamentalists try to identify companies with high growth

Snapshot

The six tenets to investing are:

- Set specific goals.
- Develop the habit of investing.
- Diversify your investments.
- Invest within your risk tolerance.
- Understand the time value of money.
- Understand the meaning of opportunity cost.

Psychological factors an investor has to guard himself from:

- Overconfidence.
- Deep regret over errors
- Overlooking opportunity cost.
- Inability to stick with an investment style and strategy.
- Listening to just one advisor.
- Marrying your stocks.
- Buying stock because it is cheap.
- Not paying attention to costs.
- Not worrying about taxes.

potential before that potential is reflected in the market price. Stock prices are determined by three factors at work: First, a properly recognized change in value, second, a more or less erroneous change in investor's perceptions of value and third, investors' emotions.

The school of technical analysis attempts to predict future stock prices by analyzing past stock prices. In essence it believes that tomorrow's stock price is influenced by today's stock price. A technical analyst is not concerned with earnings, ratios, estimating growth and appropriate discount rates. Instead all that occupies his attention is only the price changes, volume, momentum and the trends. The underlying premises of technical analysis include tenets that (a) subjective estimates of value are simply too imprecise and are thus effectively irrelevant and (b) future price fluctuations may be predicted through analysis of historical price movements, resistance and support relationships and other factors that impact directly on the price.

The third school of investing is the efficient market theory. Efficient markets indicate that investors (or at least the vast majority of investors) cannot expect, on average, to beat the market consistently. The reasons according to efficient market theorists include: If a stock is undervalued and offers an excessive return, investors would seek to buy it, which would drive the price up and reduce the return that subsequent investors would earn. Conversely if the stock is overvalued and offers an inferior return, investors would seek to sell it, which would drive its price down and decrease the return for subsequent investors. However, there are certain exceptions to the efficient market theory known as anomalies. They are the price-earnings effect, the small firm effect, the January effect, the neglected firm effect, day-of-the-week effect and the Value Line Investment survey effect. All these anomalies offer exceptions that prove that certain stocks might yield higher returns than others.

The Y-Process is founded on two quintessential market concepts: (1) The law of supply and demand and (2) That stock prices tend to move in trends. Based upon the trend formed, the Y-Process detects the transition from bull to bear or from bear to bull very close to these major cyclical turning points. Two factors are used in determining this transition: The market's trend and moving average. A moving average is a mathematical trend line. The primary purpose of a moving average is to smooth out

the numbers of the data points in order to modify minor and irregular fluctuations. Moving averages can also be useful as the basis to formulate a stock market (or stock portfolio) forecasting system. When the moving average trend line is penetrated by the Index, the market trend changes direction in both the intermediate and long-term. For example, in July 1990 and August 1990, both 3-month and 9-month moving averages were violated to the downside, and again were penetrated on the upside in November 1990 and January 1991 respectively.

The exponential moving average is used instead of the simple moving average to search for the optimum Y-Process number. The index used for the extensive search is the S&P 500 and the index's closing price each Friday was the data point for the Y-Process number. The Y-Process number is unique because all other moving average numbers lag the market. The Y-Process number provides the buy-in value of the stock, fund or ETF. In addition to the Y-Process number there is another number that should guide the users of the Y-Process. The risk index or R, which indicates the investor as to how far away he or she is from the dreaded bear market onslaught. Mathematically put, this would mean

$$Y_1 = (P \times C_1) + (Y_2 \times C_2)$$

$$R = [(P - Y_1) \times C_3] + P$$

A change from a positive risk index to a negative one indicates that the market's trend was penetrated to the downside sometime during the week. This signals the investor to move from an aggressive position in the stock to a defensive position out of the stock and into money markets. Likewise a change in the risk index from a negative to a positive number during the week and those weeks that follow with negative signs signal the investor to move from a defensive position to an aggressive position.

Since dividends have not been included in the Y-Process calculations, it is necessary to neutralize their effect. The approach to neutralize the x-dividend effect is to subtract the x-dividend amount from the previous closing prices of the stock for the past 16 weeks.

The Y-Process trading rules

Rule 1: When a stock you own drops in value violating its Y-Process number to the downside, you must sell that stock as soon as possible after the violation.

Rule 2: You may not buy-back the same stock in the same week that you sold it. However, you may buy another stock or leave your money in the money market or equivalent.

Rule 3: When you buy a stock, you should buy it at or above the Y-Process number. To buy is your option not a requirement.

Back Testing proves that the Y-Process has a high success ratio. In fact, it had never had a loss-making year in the last 71 years. It works so well because its trading decisions are the automatic result of the price action of the stock market without any consideration of fundamental, economic or political factors. The second factor that contributes to this success is its ability to convert human sentiment into numbers that in turn can be manipulated by a computer, thus it eliminates human emotion from the decision-making process. The Y-Process is yet another anomaly of the efficient market theory. However, there are certain caveats in the form of costs, timely fashion to act on the conclusions of the Y-Process, etc. The Y-Process comes in use to make the decision but the process of transferring the orders to buying or selling stock involves a number of details. An investor has to be very clear of the nitty-gritty of stock buying and selling. ■

DG Prasanna, Team Analyst

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Opening of three new ICFAI Offices

We are happy to inform that ICFAI has opened offices at three more locations viz. Gurgaon, Thane and Visakhapatnam with the objective of providing programs information, counseling, administrative and other services to the existing and prospective students of ICFAI. The students of these cities are welcome to contact the ICFAI Offices for clarifying queries and getting other services at the addresses mentioned below:

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Candidates of the DBF/PGDFA Program who are enrolled on or after April 01, 2000 may note that they are required to pay Annual Service Charges every year. The period of one year is reckoned from the date of enrollment.

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All candidates who have enrolled in the DBF/PGDFA program on or after April 01, 2000 and not yet remitted the Annual Service Charges for the year 2001-2002 and/or 2002-2003 are required to remit the Annual Service Charges with a late fee of Rs. 100 per month. Annual Service Charges can be remitted using Form 110 of the ICFAI Candidates Regulations, 2002.

The candidates, who do not remit the Annual Service Charges, will be denied all the student services without further notice.

Results of April 2002 Examinations

Candidates are requested to note that the results of April 2002 examinations will be declared on the Website www.icfai.org as per the schedule given in Annexure III of the ICFAI Candidates Regulations 2002. Candidates can view their results and download the Memorandum of Marks using the password. Candidates who have registered for the examination earlier also can use the same password, which was provided to them. Candidates who have appeared for the examination for the first time in April 2002 can create their own password by clicking the icon "New User". We hope the candidates would find this facility useful and convenient.

New Test Centers

With effect from July 2002, ICFAI examinations are proposed to be conducted in 50 cities. The addresses of Test Centers in 29 cities are given in Annexure IV of the ICFAI Candidates Regulations, 2002. The names of 21 additional cities where ICFAI examinations will be conducted are as follows:

City	Center Code	City	Center Code	City	Center Code
Agra	133	Jamshedpur	140	Nasik	147
Allahabad	134	Kolhapur	141	Noida	148
Amritsar	135	Ludhiana	142	Ranchi	149
Faridabad	136	Madurai	143	Siliguri	150
Ghaziabad	137	Mangalore	144	Surat	151
Gwalior	138	Meerut	145	Udaipur	152
Jabalpur	139	Mysore	146	Varanasi	153

The addresses and other details of the Test Centers in the above cities will be informed to the candidates in due course through Website.

Courseware for Level II and Level III of the PGDFA Program

Candidates who are enrolled in the Accelerated PGDFA Program are advised to note that as they are required to appear for and pass the Groups in sequential order, the courseware for Level II will be supplied to them only after they complete Groups Alpha and Beta and register for the examinations of Group Gamma of Level I of the PGDFA Program so that they will receive the updated courseware. Similarly, the courseware for Level III will be supplied to them after they complete Groups Delta and Epsilon and register for the examinations of Group Kappa of Level II of the PGDFA Program.

July 2002 Examinations

The next ICFAI Examinations are scheduled to be conducted from July 06, 2002 to July 28, 2002. The last dates for submission of the Examination Registration Form is as under:

ERF accepted from		: May 06, 2002
Last dates for submission of ERF	Without late fee	: June 08, 2002
	With late fee of Rs.100	: June 15, 2002
	With Walk-in Registration fee:	Date of Examination

Candidates intending to appear for July 2002 examinations are advised to submit the ERF before the last date mentioned above. Candidates are required to check their eligibility and ensure the following before submitting the ERF for July 2002 examinations:

- There are no fee dues.
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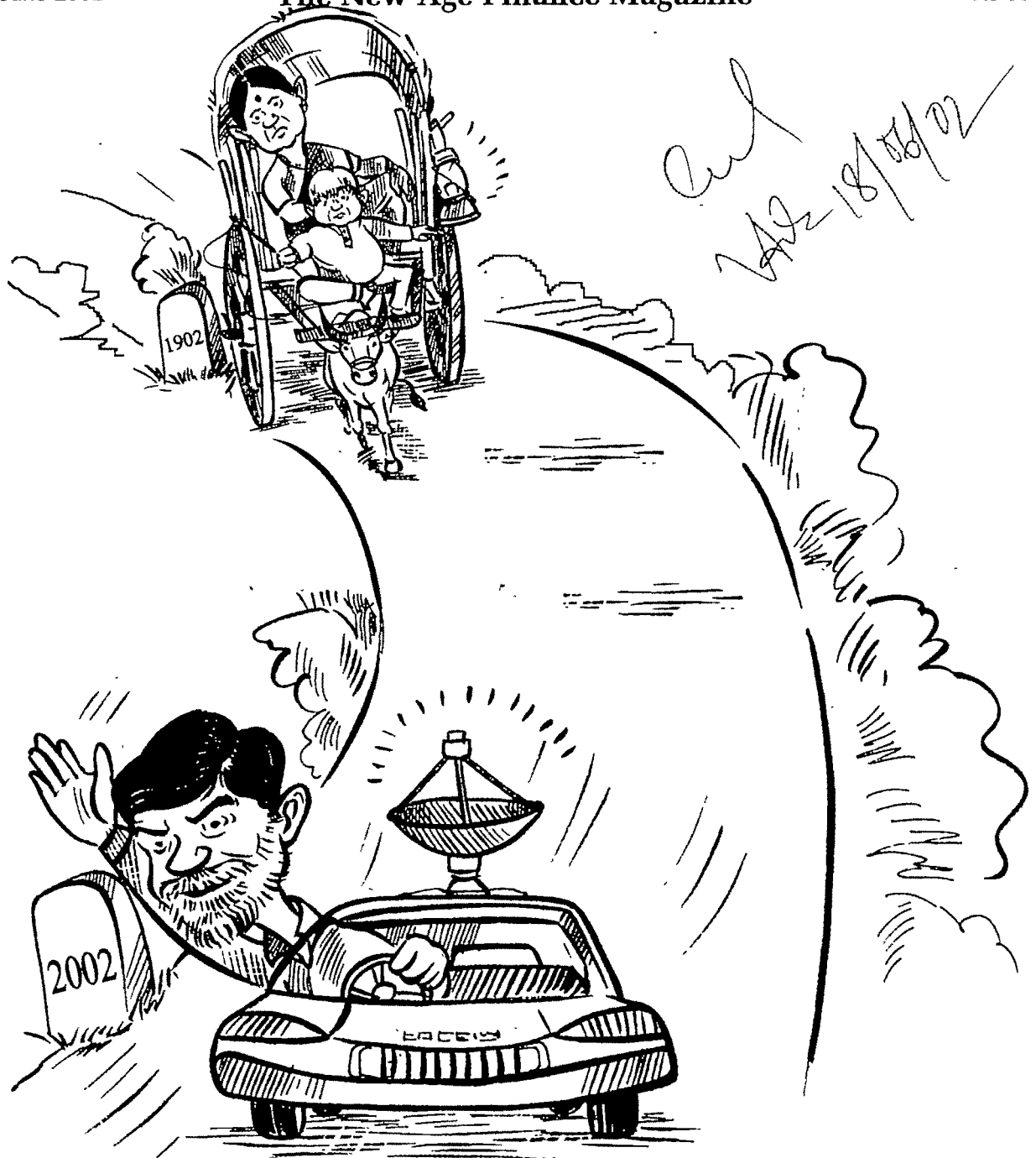
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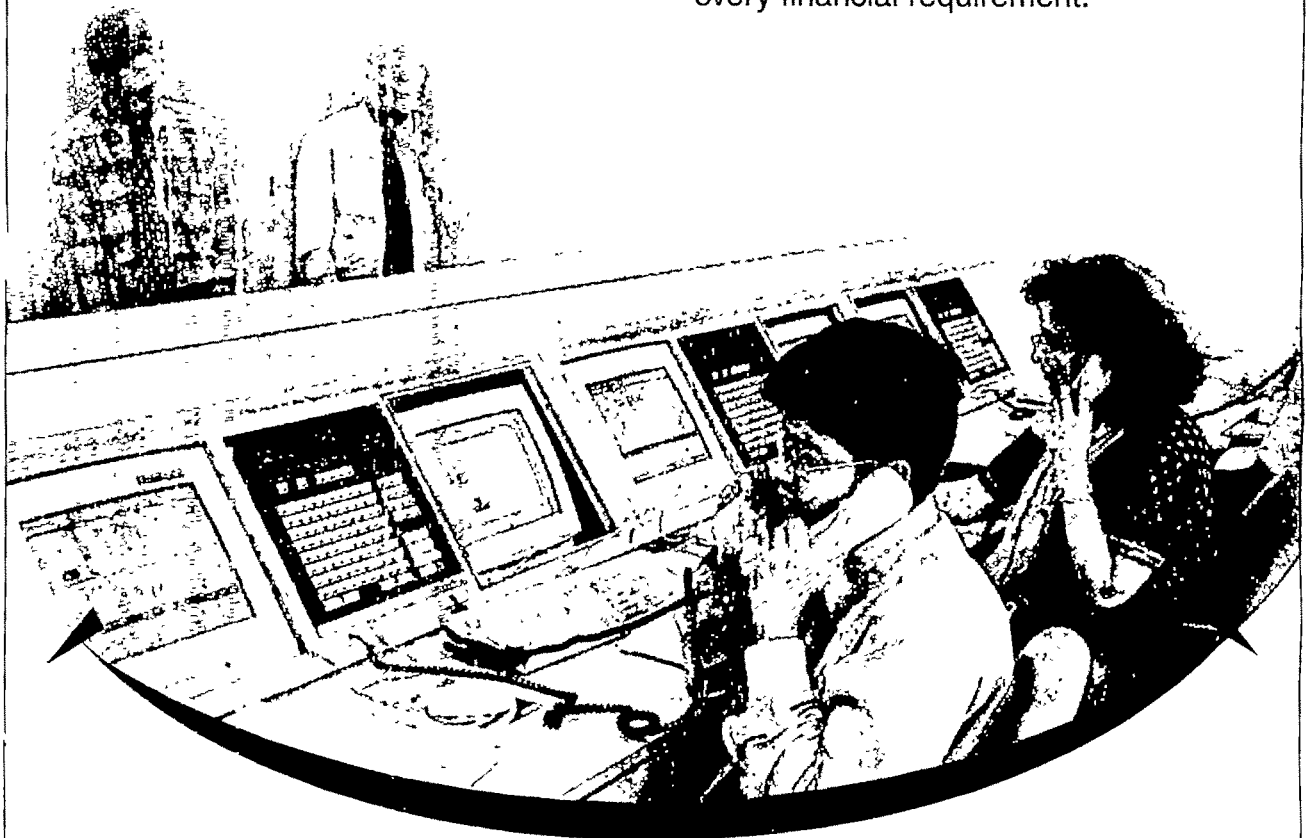
A Tale of Two States



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Editor E N Murthy

FOCUS

The Road Not Taken

Economic reforms, including liberalization opened up new vistas for the Indian states to script their destiny towards economic development. Yet, a decade of reforms later, regional disparities mar the formidable vision built by our leaders. Two states which reflect this regional imbalance are Bihar and Andhra Pradesh. 'A Tale of Two States' is an attempt to address the reasons and remedies for such regional imbalances prevalent among Indian states. Bihar, which has been labeled as being the poorest Indian state since 1971, also carries the cross of having the highest rate of population growth (28.43 percent), lowest literacy rate (47.53 percent) and substantially high rates of crime and lawlessness. On the other end of the spectrum is Andhra Pradesh, a classic example of a state on the move. In the last five years, with a growth rate of six percent or more annually, the state has even managed to challenge the nation's overall growth rate. Even the much hyped about economic downturn did little to dampen the spirit of Andhra Pradesh and its now famous IT-driven development model.

The disparity between both these states is the result of several years of strategic transformation for one and hopeless neglect for the other. Entrepreneurial spirit, visionary leadership and aggressiveness on the part of the State Government to place Andhra Pradesh on the world map have fostered economic growth in the last five years. On the other end, Bihar is lost amidst caste conflicts, corruption and sheer indifference by political leaders whose sole aim seems to be to generally drift along in power till the next elections.

The article also addresses the unfinished agenda of development that Andhra Pradesh has set up for itself along with the remedies to solve Bihar's problems. Efforts to set right Bihar's myriad problems need a strong political will to do some strategic thinking and guide the state in the right direction.

In the international arena, post-Enron, corporate America has woken up to a more rigorous monitoring of accounting standards. The spotlight has shifted to GE, the world's most admired company, which has unfailingly delivered predictable earnings. Analysts and investors are questioning its very ability to perform so consistently, quarter after quarter, year after year. They are now trying to decipher the questionable accounting practices that have enabled them to achieve this. GE, once symbolic of all that was good and worth emulating in corporate America today has a tarnished image.

This brings us to the moot question as to what are the reasons that prompt companies to manage their earnings to project a picture of sustained growth? The answer lies in the excessive focus on stock price that has become a hallmark in the recent era. Two reasons are responsible for this: The CEOs' and CFOs' rewards being tied up to stock performance and the focus of investors, analysts on the stock prices. Markets rewarded smooth earnings and those who did not deliver were punished rather brutally giving companies another reason to manage the numbers. However, now there is a shift from earnings to quality of earnings.

Jeffrey Immelt, CEO of GE observes that it is not enough to just deliver earnings; today it is all about quality. If this kind of inquisitive quest for quality earnings continues and evolves a model that would emphasize on quality rather than on numbers, the market driven model of economy will survive.

Ch Rajeshwer

LETTERS TO THE EDITOR**Low Inflation or Unreal Inflation?**

I have gone through the interview on low inflation of Dr. Atmanand (*Analyst*, May 2002). Almost every person belonging to the salaried class knows that the rate of inflation, which is presented in the media, has hardly any practical relevance. It has been truly commented by him that more than 50 percent of the items are not included while calculating WPI (two to three percent) and ordinary consumers have to pay the price, which is based on CPI (nine percent) whereas the DA is paid to the salaried person based on WPI. Therefore, the Government agencies which calculate inflation should base their index on CPI rather than WPI, so that the salaried class does not suffer owing to low DA being made payable to them, besides suffering huge cuts in their salaries in the name of tax.

RD Bhardwaj

Prashant Vihar, New Delhi 63

Far Cry

The cover story on commoditization of the IT sector (*Analyst*, May 2002) made an interesting reading. Though the article with comments from domain experts has explained the process and progress of commoditization in the IT industry, I have my own reservations regarding the extent to which it will materialize. This is especially true of the software sector where quality makes all the difference. And undoubtedly, it is an established brand that can ensure a good acceptable quality. I feel branding will never lose its importance and though the hardware sector is witnessing commoditization, it is a far cry for the software sector.

Nalin Jain

Mumbai

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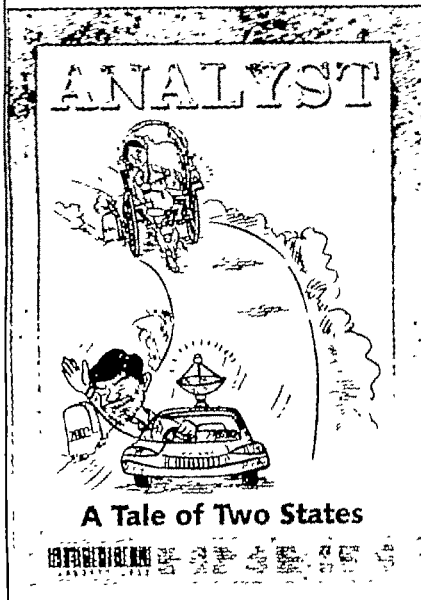
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COVER STORY



A Tale of Two States 19

Two states—Bihar and Andhra Pradesh—one with a rich history and another, which is making one. The contrast becomes all the more palpable given the fact that Andhra Pradesh, for long an indistinguishable expanse on the map of India, is emerging as a contender for all that means progression. Bihar, on the other hand, with a repository of natural resources, continues to flounder earning negative encomiums. The creation of Jharkhand that has truncated Bihar has deteriorated the economy further. With meager natural resources and hardly any industries, there is little prospect for further progress. Gloom and despair is omnipresent. By contrast, Andhra Pradesh has paved its way to progress, trying to overcome all bottlenecks.

SPOTLIGHT

GE

In the line of fire 16
GE was always admired for its double-digit earnings, its acquisitions and its management. But, in the wake of high-profile corporate collapses like Enron, investors have sharpened their scrutiny. Well-known personalities in the financial sector, like Pacific Investment Management Company's, Bill Gross, have alleged that GE has been fueling its growth via short-term debt through the issuance of commercial paper. Critics are also raising doubts about its consistent earnings and acquisitions-led growth strategy. In this skeptic state of affairs, the world's most admired company has to explain its greatness.

CASE STUDY

Xerox Corporation

Documenting problems 44
With accounting fraud allegations clouding Xerox, for a while it looked like another Enron was in the making. But by agreeing to pay the largest fine ever for financial fraud, although not admitting any liability,

it has settled all its pending issues with SEC and hopes to bring in some sense of credibility on its damaged reputation. However, allegations are not the only problems that Xerox is embroiled in. Tough competition and the sluggish economy has already taken its toll on the company. Although still the market leader in photocopiers, the company is on the threshold of some tough times ahead.

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National

Positive forecast

Tensions are again high between India and Pakistan after a May 14 terrorist attack in Indian-administered Kashmir, apparently by Pakistan-based militants. The possibility of a war has increased, and even a small, conventional fight between the nuclear-tipped neighbors would have huge diplomatic costs for both. The increased focus on Pakistan might help the BJP-led coalition and the Prime Minister, however. The cross-border conflict could divert criticism of their mishandling of the ongoing violence in the Indian state of Gujarat since February. However, the economy is expected to fare well in 2002. According to forecasters, polled by *The Economist*, GDP growth should reach 6.3 percent, due to a booming agricultural sector. Through its EXIM policy 2002-07, India scrapped quantitative restrictions on exports of all but a few sensitive items. The move will primarily affect agricultural items, and should boost rural incomes.

Booming telecom

Telecom market intelligence leader Gartner Dataquest has forecast that India will show a double-digit growth in the sector with its telecom services market reaching \$14 bn in 2006. India's fixed telecom services market too is facing strong competitive pressure, especially on the pricing front, with the privatization of long distance services, according to Gartner Dataquest's latest report for Asia-Pacific. It says growth in the Indian market will be increased by deployment of phone lines supported to an extent by the rollout of wireless local loop. Going forward, contribution from local calls and rentals will shore up the revenue base. Data and Internet services will grow faster and their contribution to total revenues will increase, in line with other markets in Asia, the report says.

Gartner Dataquest expects that India and China, the world's two most populous countries, are likely to be the rare performers in a subdued fixed-line phone market in Asia-Pacific. The world's leading technology researcher says in a statement that Asia-Pacific fixed-line

phone service revenues would grow by single digits through 2006, as market growth slowed in the region's developed countries. "Asia is facing the same problems which the western countries faced several years ago when prices plunged as a result of liberalization," To Chee Eng, Principal Analyst with Gartner's Asia-Pacific telecom and Internet research group, says in the statement. But China and India are set to buck the trend. China, already one of the world's biggest telecom markets, was forecast to grow by a compounded 7.9 percent from 2001 through 2006 to \$27 bn in fixed-line revenues, the Gartner statement says.

India has just around 35 million fixed-line phones now, which analysts consider is way too low for a country of over a billion people.

India Inc. on overseas shopping spree

The year 2002 just might go down as a year when India Inc. went on record overseas corporate shopping binge. In the first few months of the year, Dr. Reddy's Laboratories announced that it had acquired two companies in the UK—BMS Laboratories Ltd. and Meridian Healthcare (UK) Ltd.—in a £9.05 mn deal. NIIT has acquired Osprey Systems Inc. and Clicktolearn in the US for \$6 mn. Several information technology and pharmaceutical companies have announced that they want to shop for companies overseas. The list includes Tata Consultancy Services, Wipro, and NIIT. Ranbaxy Laboratories, which bought three companies overseas—Ohm Laboratories in the US, Rima Pharmaceuticals in Ireland and SP Medicamentos in Brazil—some years ago, wants to be listed in the US to build up a war chest for further acquisitions.

The BPL group is acquiring a Slovenian television producer called Elektronika Valanje. The Onkar Singh Kanwar-controlled Apollo Tyres Ltd. has signed a memorandum of understanding to pick-up a 76 percent stake in a Chinese tyre producer. Indian Rayon & Industries, the AV Birla group company, is scouting for carbon black facilities in China, Romania and the Ukraine. Tata Steel is

considering the possibility of acquiring a large ferro-chrome project overseas, even as the Taj group of hotels continues its quest for hotels in South-East Asia and in the US. Analysts say several leading domestic companies are still reluctant to look at overseas buyouts because of cultural and post-acquisition integration travails. However, no one has yet announced in 2002 a big bang acquisition on the lines of Tata Tea's acquisition of Tetley of the UK in 2000 for over Rs. 18 bn.

Economic growth blues

According to the Centre for Monitoring Indian Economy (CMIE), India's economic growth is likely to slow down in the current financial year.



Weakness in the farm and services sectors would combine with moderate expansion in the industrial sector to pull India's GDP growth rate in 2002-03 (April-March) to 4.5 percent from an estimated growth of 5.7 percent last year. That is lower than the Reserve Bank of India's projected GDP growth of 6.0-6.5 percent and the Asian Development Bank's forecast of 6.0 percent. The Government has not made any projection. The CMIE forecasts the agricultural sector to expand by two percent in 2002-03 against an estimated growth of 7.2 percent last year.

About two-thirds of India's more than one billion people depend directly on agriculture for their livelihood in the world's second most populous nation. The CMIE forecasts the industrial sector to grow by about four percent against 2.7 percent last year while the services sector was projected to expand by 6.5 percent against 6.6 percent. The farm and industrial sectors contribute about 25 percent each to GDP, while the services sector accounts for the rest. India's economy is ranked the world's 13th largest by 2000 GDP size, according to the World Bank. In dollar terms, it vies with South Korea for the position of third largest economy in Asia, behind giants Japan and China. The CMIE says the past year was India's most difficult since facing a balance of payments crisis in 1990-91 and it expects the situation to deteriorate further. "We believe the economic scenario would change in 2002-03 for the worse." ■

International

Asia's top business center

Singapore has overtaken Hong Kong as the best place to do business in Asia, according to a survey by the Economist Intelligence Unit (EIU). Hong Kong slipped from top spot to second because of its concern over its growing deficit, openness to competition, and the adaptability of its labor force. EIU cited fears of political interference from Beijing as another reason for Hong Kong slipping in its poll, which aims to forecast regional business conditions for the next five years. The EIU findings will bode well for Singapore, which is trying to stem a recent exit of business to Hong Kong, such as the investment banking operations of Lehman Brothers and the top regional management of Philips, the Dutch electronics group. Singapore's healthy fiscal surplus would allow it to cut taxes while Hong Kong's fiscal deficit might force it to raise them. Singapore recently announced it would reduce top corporate and personal tax rates to a uniform 20 percent over the next three years, although they would remain higher than Hong Kong's 16 percent corporate tax rate and 15 percent flat-rate income tax. But economists believe that tax cuts alone will not improve Singapore's competitiveness as a business center because it suffers from a limited talent base and is in the center of South-East Asia as the region loses manufacturing investments to China.

Strong economic performance

China confounded pessimists with strong economic figures showing that exports, industrial production and inflows of foreign investment in the first four months of this year have all exceeded forecasts. Industrial output leapt by 12.1 percent in April 2002 to \$31 bn, the national bureau of statistics says. This is compared with a 10.9 percent increase in the first quarter and a target of nine percent for the whole year set by the State Economic and Trade Commission, the key industrial ministry. Foreign Direct Investment (FDI) was also extremely strong, soaring by 29.06 percent year-on-year to \$14.14 bn in the first four months. Economists cautioned,



however, that the economic health of the economy was in some senses skin-deep. Aggressive fiscal stimulus spending by the Government is straining state finances, state banks continue to lend despite high levels of non-performing loans, consumer prices are falling and unemployment is on the rise.

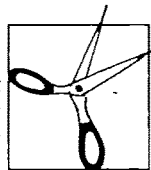
But these structural issues aside, the performance in the first four months of the year has been stronger than pessimists predicted. The increase in FDI was attributed, in large part, to the growing opportunities to foreign companies following China's accession to the WTO, secured late last year. Official estimates have put actual FDI at \$50 bn this year; up from \$46.8 bn last year—but the current rate of increase suggests that this figure may be eclipsed.

On the corporate front, statistics showed that the best performers were once again foreign-invested enterprises, many of them export-oriented, and Chinese shareholding companies, made up largely of the companies listed on domestic exchanges and in Hong Kong. The state-owned sector, which is still shedding workers rapidly, continued to be the poorest performer but still managed a 10.9 percent rise in production in April.

Cut taxes to revive economy

The sun has finally begun shining on the Japanese economy. The Government announced in its monthly economic report for May 2002 that the economy had bottomed out, although it cautioned that "the economy continues to be in a difficult situation." As a basis for its assessment, the report referred to increases in exports, mainly to the US and Asian countries, progress in inventory adjustment and the bottoming out of industrial production. In tandem with the improvement in the global economy, the Japanese economy is expected to emerge from its prolonged recession, but as this is expected to be extremely gradual, deflation will still remain a problem.

The situation is extremely delicate. If the Government relaxes its policy now, the economy will not be able to get on the



recovery track and might even start deteriorating. The Government has upgraded its official economic assessment from the April report, which says the economy "is moving toward bottoming out." This is because the recovery in exports is certain to increase industrial production.

Uncle Sam under fire for 'damaging' trade curbs

The heads of the world's three main multilateral economic institutions joined forces to condemn rising US protectionism, saying it harmed global growth and set back economic reform and open markets. The unprecedented display of disapproval came in a joint statement by Horst Kohler, managing director of the International Monetary Fund, Mike Moore, Director-General, World Trade Organisation, and James Wolfensohn, President, World Bank. Although the statement did not mention the US by name, it comes amid increasing international condemnation of US decisions to boost farm subsidies and curb steel imports. Their words reveal the fear that Washington's actions could set off a chain reaction of worldwide protectionism that would particularly hurt developing countries. The statement says, "Any increase in protectionism is damaging." Such actions will hurt growth prospects where fostering growth is most essential. And they send the wrong signal, threatening to undermine the ability of governments everywhere to build support for market-oriented reforms."



... The statement was delivered to a meeting of ministers from more than 40 countries at the Organization for Economic Co-operation and Development in Paris, at which the US was attacked for increasing agricultural-support spending in its farm bill and for the steel import restrictions. It called for liberalization of trade in agriculture and textiles, which are protected US markets. ■

N Janardhan Rao, Team Analyst

Merger street

Mega British merger

Britain's power and gas transmission monopolies plan to merge in a bid to create a £29 bn (\$41.9 bn) energy delivery giant that will be a powerful predator in the US. National Grid, the electricity transmission utility, and Lattice Group, the gas transmission company that owns Transco, hailed the transaction as a merger of equals, although Lattice shareholders will receive a 3.6 per cent premium for their shares. The combined group will be one of the 20 largest companies in the UK and the only British utility of a size capable of rivaling European groups such as Eon of Germany or Electricite de France.

Company sources maintain that the merger would leave the groups well placed for acquisitions in the liberalizing North East region of the US, where National Grid already owns Niagara Mohawk and New England Electric Systems. Its firepower has been hit in the last few months by the collapse in the value of Energis, the UK telecommunications company in which it holds a 32.5 per cent stake, and a £290 mn write-down in the value of its Latin American telecommunications businesses. However observers opine that the combined group would be capable of a \$3 bn acquisition in the US—about the same size as the Niagara Mohawk purchase—every two years. Analysts believe that potential targets include Albany-based Energy East, which has a market capitalization of \$2.6 bn; Northeast Utilities of Hartford, which is capitalized at \$2.7 bn; or Nstar of Boston, which has a market valuation of \$2.4 bn.

As per the agreement, National Grid shareholders will retain their shares in the company—to be renamed National Grid Transco—and Lattice shareholders will receive 0.375 shares in the enlarged group for each Lattice share. National Grid shareholders will hold 57.5 per cent of the company and Lattice shareholders will hold about 42.7 per cent. Both the companies have a debt of about £7 bn each. Analysts said the deal

appeared to make strategic sense for both companies.

Vivendi to buy Southern for £2 bn

Environment, the French water group confirmed that it would buy Southern Water of the UK for £2.05 bn (\$3.01 bn), subject to regulatory approvals. The deal comes just two months after Southern was sold by Scottish Power to First Aqua, a private investment vehicle backed by Royal Bank of Scotland. Company sources said that at the time of the transaction it had a put-and-call option to buy £374 mn of non-voting preference shares in First Aqua if the investment vehicle offered to sell Southern within six months. The price paid by Vivendi for Southern is the same as that paid by First Aqua in March. The French group, which was spun out of media group Vivendi Universal in 2000, believed that the acquisition would enhance earnings from 2003 onwards. Following the deal, Vivendi will have a 10 per cent share of the £10 bn (\$9.18 bn) English and Welsh water market and will also enter the UK waste market for the first time. Sources at First Aqua maintained that the transaction would leave Southern well placed to continue to be one of the most efficient water companies in the UK. It hoped to complete the deal during the fourth quarter of this year, subject to clearance by the European Commission, UK Competition Commission and Britain's Department of Trade and Industry.

Vivendi already owns Three Valleys Water, North Surrey, and Tendring Hundred and Dover water suppliers in the south of England, which generated revenue of €307 mn in 2000. The group hopes to generate synergies between the operations and Southern, though investors in March expressed some reservations about the low growth rate of the UK water sector. Scottish Power had planned a £1.7 bn refinancing of Southern after indicative offers from potential bidders, including a joint venture between Vivendi and Centrica, the UK energy

utility, were said to be too low. The sale of Southern to First Aqua released £300 mn more cash than the refinancing would have done, boosting Scottish Power's capacity for further UK and US acquisitions.

Sears in a \$1.9 bn deal

Sears Roebuck, one of the biggest US retailers, is buying the catalog and online retailer Lands' End for \$1.9 bn as it seeks to revive its fortunes after losing ground to rivals such as Wal-Mart. The deal brings together what was once the world's largest retailer, whose Big Book catalog business was for decades a symbol of middle America, with a new-breed direct seller of clothing. Sears is offering \$62 in cash per Lands' End share. Sears, now a department store and online retailer, has struggled in recent years to compete with innovative discount rivals such as Wal-Mart, the superstore chain, and Kohl's, a fast-growing department store retailer. The addition of Lands' End aims to jumpstart sales growth in its stores, alongside its efforts to streamline and revamp its retail operations. Apparel has long been a weakness at Sears, despite its strength in "hardlines" such as tools and appliances. The company hopes owning a respected national brand which could improve clothing sales and boost sales growth overall. Sears is also shifting its department store format to a more self-service system. Company sources maintain that the Lands' End acquisition would "further differentiate Sears as a destination for nationally-recognized brands." The deal is part of a broader trend among big US retailers to buy up exclusive brands in an effort to mark themselves out from rivals.

The deal puts Gary Comer, Lands' End's 76-year old Founder and Chairman, close to the billionaire bracket. He and his family trust own more than 50 per cent of Lands' End, founded in 1963 as a mail order retailer of sailing equipment. It also gives Lands' End a ready-made retail distribution network alongside its existing catalog and Internet operations. Sears will introduce some Lands' End products into many of its 870 stores by autumn 2002, and have products in all its



VIVENDI
UNIVERSAL



stores by a year later. Analysts said Lands' End was a "unique asset", thanks to the quality of its clothing and execution of its direct merchandising business. Daniel Barry, retail analyst at Merrill Lynch, said in a research note that the deal was a good strategic move for Sears, though unlikely to affect earnings until 2004. Sears' advisers were Morgan Stanley. Lands' End was advised by the Peter J Solomon Company.

Birlas buy Yamaha's share

Yamaha Motor Company, one of Japan's leading motorcycle-makers, has sold its entire holding of 27.9 percent, or 29.22 lakh shares, in Birla Yamaha to Birla International, an associate of the Indian promoters. After the acquisition, Birla International will hold 29.8 percent stake in the company and the acquisition is part of exchange of stakes between the Indian promoters and the foreign collaborator as per the information given by Birla Yamaha to the Bombay Stock Exchange. The price of the deal is not known. Indian promoters hold over 59 percent of BYL's equity of Rs. 10.5 crore as on December 31, 2001, and would not be required to make an open offer to the other shareholders as Indian takeover guidelines exempt promoters transferring stakes to one another from making a public offer. Institutions (including FIs, FIIs and MFs) hold 16 percent, with Indian public and other private bodies owning the remaining 25 percent. BYL is a leading player in the portable genset and multi-purpose engines industry.

KPMG to acquire Andersen

If everything goes right then KPMG Consulting would end up with the bulk of Andersen Worldwide's global consulting business, continuing the disintegration of the professional service firm tainted by its role as former auditor of energy trader Enron. KPMG Consulting, which was spun out of KPMG's tax and auditing business in late 1999, has signed a letter of intent to buy Andersen's consulting units in 23 countries for \$284 mn (€314 mn) in cash, and would also issue up to 6.5 million new shares to lock in Andersen partners. The legal action facing Arthur Andersen, the US unit of Andersen Worldwide, over its role in the Enron scandal has prompted the break-up of its global franchise as staff and clients



defected and rivals snapped up business units.

Analysts said KPMG Consulting had negotiated a good price for Andersen and would secure product and geographical diversification, reducing its reliance on US public-sector business, notably through Andersen's strength in consumer and industrials business.

Company sources at KPMG Consulting maintain that Andersen was a good strategic fit with little overlap. The firms share only 15 of their respective top 100 clients. KPMG Consulting hopes to close the individual deals in 30-45 days. The purchase of the US business is contingent on the "satisfactory resolution" of potential liability issues facing the consulting business. Arthur Andersen is on trial after being indicted for obstructing the US judicial investigation into Enron.

Spanish pay-TV rivals to merge

Spain's rival satellite digital television companies have agreed to merge their services in an effort to stem their operating losses. The agreement between Telefonica, Spain's largest company, and Sogecable, controlled by Vivendi Universal and Prisa, a Spanish media group, will create a single pay-TV company in Spain with 2.5 million subscribers and sales of €1.3 bn (\$1.2 bn), as per the companies' statement.

Telefonica had been seeking a merger after concluding that the Spanish market was too small to sustain rival pay-TV services. Telefonica and other minority partners in Via Digital, its satellite pay-TV service, have agreed to subscribe to a 23 percent capital increase in Sogecable, a listed company that owns Canal Satellite Digital, the market leader. Telefonica, Vivendi Universal and Prisa will hold equal stakes in the expanded company, although Sogecable will be effectively controlled by Vivendi and Prisa because they have a shareholders' pact. The arrangement appears to have the blessing of the Spanish Government, although it will have to be referred to Spain's competition watchdog. The difficulties of pay-TV groups elsewhere in Europe are understood to have softened the government's initial opposition to a merger in the media sector. Telefonica had been lobbying the Government to allow a merger between Spain's rival



digital platforms because losses at its media division had become unsustainable.

Vivendi to sell remaining £1.7 bn stake in BSkyB

Vivendi Universal finally drew a line under its relations with British Sky Broadcasting (BSkyB), the UK satellite broadcaster owned by Rupert Murdoch, with the sale of its remaining stake worth £1.7 bn (\$2.5 bn). The move will sever Vivendi's ownership ties to BSkyB, built up during a raid in 1999 that marked the start of a period of torrid relations between Jean-Marie Messier, Vivendi's Chief Executive, and Murdoch. It will also bring to an end months of uncertainty about the overhang on the BSkyB share price. The French media group has instructed Deutsche Bank to start book building for the sale of the remaining 250.6 million BSkyB shares it held on Vivendi's behalf. It also brought forward the exchange of 150 million shares for equity certificates. Vivendi hopes the deal will ease recent pressure over the size of its €33.8 bn debt pile, and avoid the risk of a credit rating downgrade to junk status.

BT and DT seek to sell €3.5 bn Eutelsat stakes

British Telecom (BT) and Deutsche Telekom (DT) are seeking to sell their combined 28 percent shareholding in Eutelsat, the pan-European satellite company valued at about €3.5 bn (\$3.15 bn). The move comes as the telecom companies are trying to focus their businesses and, in DT's case, reduce its debt levels. DT's €67.2 bn debt pile is one of the highest in Europe. Poor market conditions have dashed its hopes to reduce debt with an initial public offering this year of T-mobile, its mobile business. BT last year slashed its £30 bn (\$43.5 bn) of debt with a rights offering and the sale of non-strategic assets. Meanwhile, the management of Eutelsat, which is based in France, is pursuing an initial public offering and looking to appoint an investment bank to co-ordinate it. The company said in February that it was seeking an offering of 30 percent of its shares to raise €500 mn, and depending on market conditions could float by the end of this year. ■



DG Prasuna, Team Analyst

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Corporates	About NSE India
Indices	The National Stock Exchange (NSE) of India Limited has genesis in the report of the High Powered Study Group on establishment of new stock exchanges, which recommended promotion of a National Stock Exchange by Financial Institutions (FIs) to provide access to investors from all across the country on an equal footing. Based on the recommendations, NSE was promoted by leading FIs at the behest of Government of India and was incorporated in November 1992 as a taxpaying company unlike other stock exchanges in the country. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994, operations in the Capital Market (CM) segment in November 1994, and operations in Derivatives segment (F&O) in June 2000. During the year 2000-2001, NSE witnessed a total turnover of Rs. 17,70,457 crore against a turnover of Rs. 11,43,268 crore in the preceding year.
Major Indices	
IISL	
Other IISL Indices	
Beta	
Publications	
Technology	
FAQ	Objectives
Press Release	NSE's mission is getting the agenda for change in the securities markets in India. Its main objectives are to:
Glossary	• Establish a nationwide trading facility for equities, debt instruments and hybrids • Ensure equal access to investors all over the country through an appropriate communication network • Provide a fair, efficient and transparent securities market to investors using electronic trading systems • Enable shorter settlement cycles and book entry settlements systems, and • Meet the current international standards of securities markets
Equities	
Listing	
Membership	
Trading	
Settlement	
Company Info	
Trade Statistics	Equities
Education	The NSE is India's leading stock exchange covering more than 400 cities and towns all over India. NSE introduced for the first time in India, fully automated screen-based trading. It provides a modern, fully computerized trading system designed to offer investors across the length and breadth of the country a safe and easy way to invest or liquidate investments in securities.
Indices	NSE started equity trading on November 3, 1994 and within a short span of one year became the largest exchange in India in terms of volumes transacted. Trading volumes in the equity segment have grown rapidly with average daily turnover increasing from Rs. 7 crore in November 1994 to Rs. 6797 crore in February 2001 with an average of 9.6 lakh trades on a daily basis. During the year 2000-2001 NSE reported a turnover of Rs. 13,39,510 crore in the equities segment accounting for 45 percent of the total market.
Market Monitor	
Technology	
FAQs	
Glossary	
Contact Us	NSCCL
Features and Options	National Securities Clearing Corporation Ltd. (NSCCL), a wholly-owned subsidiary of NSE, was incorporated in August 1995 and commenced clearing operations in April 1996. It has been set up with a philosophy to sustain confidence in clearing and settlement of securities, promoting and maintaining short and consistent settlement cycles; to provide counter-party risk guarantee, and to operate a tight risk containment system. It assumes the counter-party risk of each member and guarantees financial settlement. It has successfully brought about an upgradation of the clearing and settlement procedures and has brought Indian financial markets in line with international markets.
Products	
Membership	
Trading	
Settlement	
Market Monitor	NSCCL carries out the clearing and settlement of the trades executed in the Equities and Derivatives segments and operates Subsidiary General Ledger (SGL) for settlement of trades in government securities. It also undertakes settlement of transactions on other stock exchanges like, the Over the Counter Exchange of India (OTCEI).
Education	
Publications	

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Investors' Corner Technology Glossary IPO Issuers Procedures NEAT IPO System Settlement Past Issues through NSE SEBI Guidelines Guidelines for NRI Subscribers Technology FAQ Glossary NSCCL Statistics Services Products Partners Notifications Committees Technology NCFM Prospectus Training Technology Debt Membership Trading System Statistics Recent Trades Valuation Prices Market Information Products	NSBIL What makes NSE the dynamic and enterprising entity that it is? The answers lie within the portals of this section. About the management, the financials, the new age technology, the members, the trading system and much more. All these facts make people realize that NSE is more than a mere market facilitator. It's that force which is guiding the industry of the region, towards new horizons and greater opportunities. Initial Public Offerings (IPO) A corporate may raise capital in the primary market by way of an initial public offer, rights issue or private placement. An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. It is the largest source of funds with long or indefinite maturity for the company. IISL India Index Services and Products Limited (IISL), a joint venture between NSE and Credit Rating Information Services of India Limited (CRISIL), was set up in May 1998 to provide indices and index services. It has a consulting and licensing agreement with Standard and Poor's (S&P), the world's leading provider of investible equity indices, for co-branding equity indices. It provides a broad range of services, products and professional index services. NSDL In order to solve the myriad problems associated with trading in physical securities, NSE joined hands with IDBI and UTI to promote dematerialization of securities and set up National Securities Depository Limited (NSDL) the first depository in India. NSDL, which commenced operations in November 1996, has completely removed the risks to investors associated with fake/bad/stolen paper by maintaining electronic records of ownership and transfer of allotments and some other associated actions. Nifty Futures A futures contract is a forward contract, which is traded on an Exchange. The National Stock Exchange commenced trading in Index Futures on June 12, 2000. The NIFTY futures contracts are based on the popular market benchmark S&P CNX NIFTY Index. The security descriptor for the S&P CNX Nifty futures contracts will be: Market type: N Instrument type: FUTIDX Underlying: NIFTY Expiry date: Date of contract expiry S&P CNX Nifty futures contracts have a maximum of three-month trading cycle—the near month (one), the next month (two) and the far-month (three). A new contract will be introduced on the trading day following the expiry of the near month contract. S&P CNX Nifty futures contracts expire on the last Thursday of the expiry month. If the last Thursday is a trading holiday, the contracts shall expire on the previous trading day. Price Bands There is no day minimum/maximum price ranges applicable for Futures contract. However, in order to prevent erroneous order entry by trading members the operating ranges are kept at + 10 percent. In respect of orders which have come under price freeze, the members would be required to confirm to the Exchange that there is no inadvertent error in the order entry and that the order is genuine. On such confirmation the Exchange may approve such order.
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TICKER

For last 40 years, tension and confrontations have marked the relationship between the United States and Cuba. The former US President Jimmy Carter's high-profile visit to Cuba, that started from May 12 is likely to ease out the strained relations. In 1959, America recognized the new Cuban Government, headed by Fidel Castro. But bilateral relations worsened as the regime impounded US properties and moved towards adoption of a one-party Marxist-Leninist system. Consequently, the United States established an embargo on Cuba in October 1960 and broke diplomatic relations the following January.

From November 2001, America began selling food to Cuba for the first

time since imposing the trade embargo. The United States policy towards Cuba is to promote a peaceful transition to a stable, democratic form of government and respect for human rights. It is a two-pronged course of action that attempts to maintain pressure on the Cuban Government for change through the trade embargo while providing humanitarian assistance to the Cuban people, and working to aid the development of civil society in the country.

America plans to gradually broaden remittances, expand people-to-people contacts, increase direct flights,

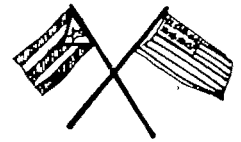
authorize food sales to independent entities, and establish direct mail service. Other measures are in offing. While humanitarian aid continues, concerns on issues like human rights, drug trafficking and terrorist activities have multiplied. Moreover, Cuba continues to provide a safe haven

to fugitives from the US justice system. Jimmy Carter voiced his concerns over these sensitive issues to Castro during his visit. On 15th he requested President Castro to allow UN Human Rights Commissioner, Mary Robinson to visit Cuba.

He even urged for democracy in Cuba and called for more bilateral trade.

The visit is more important for Cuba because the collapse of Soviet Union spelled economic doom for the country. Cuba has witnessed more than a decade of growing impoverishment and improving trade relations with US may be a promising glimmer of hope. Carter is accompanied by a delegation of American business people which is exploring investment opportunities and trying to understand the largely underdeveloped market.

CSV Ratna



The Government of India has at last made some progress in evolving a business services price index. Apparently, this index will complement the Wholesale Price Commodity Index (WPI), which is widely acknowledged as the true indicator for measuring inflation. But is the WPI a true indicator of the inflation rates prevailing in the economy? The services sector is shunned by WPI when calculating the inflation rates and this is the sector that contributes over 50 percent to the Gross Domestic Product (GDP). Currently, the WPI only reflects the price movements of manufactured goods, which constitute about 17 percent of GDP. Therefore, the need of a separate index for services sector arises, as it is a more accurate measure of inflation given that it is growing at a rate faster than the manufacturing sector. As a result, the prices of services are growing at a faster rate, which implies that WPI is depressed to that extent.

Business Services Price Index is not a new phenomenon globally. Many developed countries have what is called, the Corporate Services Price Index (CSPI) that reflects the price movements of various services offered by the corporates. For example in UK, CSPI was started with an intention to meet the increasing demand for information from both within

and outside government. There the CSPI measures the quarterly movement in the prices of services.

The new index supposedly mirrors the price movements of services such as banking, insurance, transportation (air, inland waters, railways, sea for freight and passengers), postal services and communications. The Reserve Bank of India (RBI) will be responsible in preparing a list of services including banking and insurance services that should be used for

the index. The Central Statistical Organization (CSO) is working out on the weights to be attached to the

individual services that would eventually be included in arriving at the index. Once the index is ready for use, three weekly indices will be used for measuring inflation. The WPI, the services price index and a composite index recording the overall price movement or inflation in the economy. Although it may take some time for the services index to be ready for use, it will definitely help people to know about the true status of inflation.



A Welcome Move

Shashidar Mishra

It's out in the open. The long-drawn tiff between Michel Zen-Ruffinen and Sepp Blatter, the General Secretary and President respectively of FIFA, soccer's highest international body took an ugly turn when it led to a verbal brawl at its executive committee meeting recently. With the President frustrating his moves for a change in the world's apex soccer body, Zen-Ruffinen tabled a 21-page dossier holding Blatter responsible for alleged accounting irregularities, conflicts of interest and corruption. Although the contents were supposedly confidential, news hawks soon had copies of their own.

The bitter row threatens to overshadow the opening of the World Cup finals in Japan and South Korea next month.

FIFA: Kicked Around

The World Cup stands next only to the Olympics as the world's largest marketing and media event. Eight out of 10 people around the world are expected to watch the four-week mega event with billions of dollars being spent. Broadcast rights alone are expected to bring in more than \$1 bn!

Zen-Ruffinen has accused Blatter for making unauthorized payments to his friends and veiling the fact that the organization's auditors, KPMG, were highly critical about its accounting practices. He quotes KPMG as saying that among other things "the status of income is

described in an inaccurate manner." According to him, FIFA has misused nearly \$500 mn ever since Blatter took over the reins as President.

Ever since he took over as the eighth president of FIFA in 1998, Blatter has been courting trouble. Same time, last year he was embroiled in a controversy of sorts over the collapse of ISMM, then the world's largest sports marketing firm and FIFA's partner in selling the television rights for 2002 and 2006 World Cup. Blatter had played a key role in recommending ISMM's joint bid for the rights with Kirch, the German media group that went bust last month.

With FIFA's own financing being dependent on the income it receives on staging the World Cup every four years, it was forced to issue \$420 bn worth of bonds last year to tide over a cash crunch till the current World Cup. The current rift between the two senior personnel causes more harm than sheer embarrassment. FIFA's failure to provide the requisite leadership might mar not just the reputation of the organization, but spell ruin to soccer as a whole.

Football lovers! Keep your fingers crossed

E Kalyan Babu



Whitney Tilson, of Tilson Capital Partners, LLC had to rapidly scribble 17 pages of insights uttered by Charlie Munger (the partner of the venerated Warren Buffett) which Tilson hadn't heard previously, in the 2002 Annual Meeting of Wesco, because no recording devices were allowed at the meeting. Starting off with some sage advice on investments, Munger relates them to "playing golf", a game which requires a lot of practice to become a skilled player. As one doesn't have all the experience that is required, it is important to keep trying to get a little better over time. Then one will start making investments that are virtually certain to have a good outcome. The keys

are discipline, hard work and practice" Munger mentions that he allows a lot of things to pass on. He categorizes investment options into three baskets: In, out and too tough and stresses that a lot of stuff goes into the 'too tough' basket. The rationale being that they need to have special insights. Avenues that are not within the special area of competency on which he could focus are simply dropped. When you reach for the money, it melts away. It was never there. Munger admits that his ability to manage things excellently is restricted. His most valuable insight

has to be, "I don't know how people cope (trying to figure everything out)."

On sitting in another company's board, Munger believes that Warren and himself have very little influence though there's an occasional exception where someone has very high regard for them. "CEOs ask for advice when a board has expertise, but they generally make their own decisions and use their staff. Regularly, the CEO decides what he wants to do and the board says yes."

Charlie Munger's Soundbites

Finally, Munger underscores the importance of science, "I think scientific literacy is terribly important...Habits of the mind formed from science are so valuable." He is amazed at how wrongheaded (the teaching is), and thinks there is fatal disconnectedness with squirrely people who don't see the big picture. And similarly feels that companies also get balkanized, the point of reference being Arthur Andersen and Enron. About them he observes, "They weren't all bad people, but their cultures were dysfunctional. It's easy to create such a culture, in which you have good people but terrible results."

Easwar SA



Capital Adequacy Norms

Primary Dealers: War with VaR

The new guidelines for primary dealers are definitely a step in the right direction. Usage of Value-at-Risk models to set aside capital will reduce the risk exposure taken up by primary dealers and lead to the development of an efficient bond market in India.

The Reserve Bank of India recently issued new guidelines to banks and primary dealers for making adequate provision to cover their potential for losses in their portfolio of government securities in case of an increase in interest rates. These guidelines are based upon the Market Risk Amendment to the Basel Accord on Capital Standards (January 1996), which stressed the need to set up capital charges for covering the market risk of banks' open positions in traded debt, forex as well as equity. This additional capital charge is over and above the capital set aside for credit risk.

The RBI guidelines decree that the capital charge for Primary Dealers (PDs) be based on Value-at-Risk (VaR) of their portfolios. VaR is the indicator of the maximum loss that a portfolio can suffer within a given time horizon at a pre-specified confidence level. According to the regulation, each PD is required to provide for capital to the tune of 3.3 times the 60-day average of the 99 percent VaR over a 30-day horizon, as measured by models developed internally. RBI's move is a progressive deviation from the past as the regulator specified the exact valuation as well as risk measurement norms for the market as a whole for the first time.

The essence of internal rating models is that market participants must understand and manage their risks on their own rather than looking for help from the regulators. With additional capital being set aside, market players will have a cushion to fall back on in case of sudden adverse changes in market prices and thereby making the financial system more stable.

However, there are some issues of concern regarding these regulations. Before discussing these issues, it is essential to understand the trade-offs that are involved in implementing these regulations. The level of capital charge is typically determined by the time horizon

over which the VaR of the portfolio is measured and the multiplication factor given by the regulator. Therefore, the longer the time horizon and the multiplication factor, higher would be the capital charge.

According to the Market Risk Amendment to the Basel Accord "an instantaneous price shock equivalent to a 10-day movement in prices is to be used, i.e., the minimum holding period will be 10 trading days" for calculating VaR. As against this, RBI has prescribed that the VaR be measured over a 30-day horizon. PDs feel that a longer holding period is unwarranted and only serves to reduce their capital available for investment. However, that is not true.

According to SL Chhatre, CEO, Fixed Income Money Market and Derivatives Association of India (FIMMDA), "The time horizon or the holding period for VaR computation is indicative of the time required to liquidate a position in any given market." Considering the nature of illiquid bond market in India and the inadequacy of instruments that can be used for hedging, it will require a greater amount of time to liquidate a risky position and hence reduce the capital required to be maintained on it. That is the primary reason for the greater time horizon prescribed by RBI. "Secondly, VaR of a portfolio is not directly proportional to the time horizon. It specifically depends on the nature of 30 day returns vis-à-vis one day returns. If there is no auto-correlation in the daily return series (an assumption that does not necessarily hold true), then the VaR will be directly proportional to the square root of the time horizon," adds Chhatre.

Then there is a second dimension. In India, PDs are responsible for market making and yet they do not have the pleasure of using hedging instruments. Market participants fear that if RBI imposes excessively conservative capital charges to cover for the interest rate risk



of their portfolios, they might be forced to take up more risky investments from their remaining free capital to arrive at an acceptable level of return on their total capital if they want to stay in business.

Irrational risk taking is precisely what the new rules want to curb. In the absence of any specific capital charges, PDs might be tempted to take up riskier investments to improve their returns. However, as per the new rules market participants can take up risky positions only if backed by enough capital. "PDs will be unable to take up more risky investments if they do not have the capital to support it. In fact, there will be incentives for increasing return while minimizing the capital required for risk," states Chhatre.

Although PDs will see their returns coming down in the short-term, the new rules are definitely in the right direction. In the long run, the adoption of proper risk management practices will definitely enable PDs to improve their returns, as there will be a natural incentive to reduce costs. All in all, a welcome move from RBI aimed at improving risk management at Primary Dealers. ■

E Kalyan Babu, Team Analyst

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SPOTLIGHT

GE

In the line of fire

GE's greatest strengths—its ability to deliver double-digit earnings growth consistently, expanding through acquisitions and its management—have suddenly turned into its weaknesses. In the wake of investor disenchantment with corporate glory, as an aftermath of Enron & Al., GE has landed at the center of the squall.

Even the world's most admired company is not spared of criticism. Bill Gross, one of the financial community's respected personalities, recently attacked General Electric (GE) for its heavy reliance on short-term debt or commercial paper (which stood at \$103 bn). Gross, a bond-fund manager at world's biggest bond fund, Pacific Investment Management Company (PIMCO), announced that he would cease buying the commercial paper of GE, because its large exposure to short-term debt made it vulnerable to huge risk during each refinancing. He alleged it was a double whammy because it used cheap short-term loans to make long-term acquisitions. He accuses GE of inflating earnings through acquisitions and cheap debt rather than through organic growth.

Gross argues that GE is enjoying a triple-A bond rating even though its outstanding commercial paper is three times the size of its bank loans when normally the two should be equal. Credit analysis boutique Gimme Credit and rating agency Moody's Investors Services echo similar concerns that bank lines for GE's finance arm, GE Capital, back-up less than a third of its commercial paper.

GE Capital: The star!

Much of investor concern about GE centers on GE Capital, the fastest growing of GE's 12 businesses. More importantly, commercial paper accounts for about 42 percent of GE Capital's debt. Agreed that short-term debt is less expensive than long-term debt, but too much of a dependence on it can expose the firm to a sudden credit crunch.

GE Capital's growth has become all the more prominent with the decline in the performance of GE Power Systems.

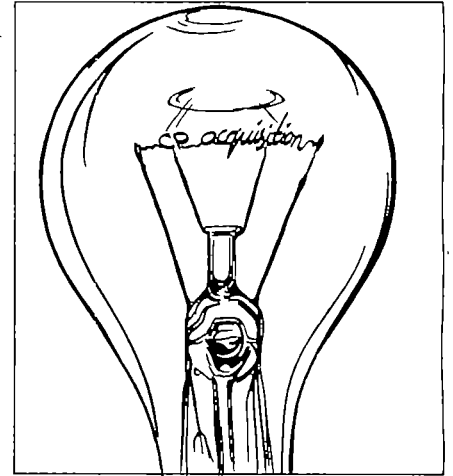
The growth at GE's star performer, GE Power Systems, has reduced as natural gas and electricity prices have fallen due to fears of an energy surplus. Thus amid this slowdown, GE Capital has emerged the star. It typically accounts for 40 percent of GE's earnings.

The six percent growth rate of rest of GE is puny against GE Capital's 22 percent growth rate over the past 15 years. Last year, GE Capital's contribution to GE's revenues hit 50 percent. If GE Capital's share of total earnings goes beyond 50 percent, investors may value GE more like a bank stock because like banks, it has relatively low margins and high debt. The problem, however, is that banks usually trade at

Short-term debt is less expensive than long-term debt, but too heavy a reliance on it can expose the firm to a sudden credit crunch

about half the P/E of industrial stocks. So, a bigger GE Capital could have negative implications on GE's multiple.

GE has both short- and long-cycle businesses under its fold. Some of them do well while others feel the slump. In a comparison, Vivendi, the French conglomerate having interests ranging from commodities to media, is facing flak for leaning too heavily on its entertainment arm. Its other businesses weren't able to bail the media interests. The "portfolio effect" didn't seem to have worked there. Like GE, it was criticized for its short-term debt. But, seemingly, GE is better managed than that troubled giant. Vivendi's troubles were largely due to its over-dependence on its entertainment arm. GE too seems to be relying a lot on GE Capital which may be a cause for concern. Can this over-dependence on GE Capital prove costly for GE? Or for that matter, could banking on a single business be harmful? Jeffrey Bronchuck, CFA and Chief Investment Officer at Reed, Conner & Birdwell says,



"No. GE Capital is a great business, the question is why do they get a higher multiple than other financial companies."

Richard J Wayman, CFA and President of www.researchstock.com, an independent equity research firm, believes, "If GE Capital suffers from the recession and there is not a pick-up in another unit, then yes it will have a dampening effect on growth. But in this scenario, all finance companies will suffer and GE's diversification may make it more attractive in the eyes of investors."

GE Capital has been criticized for its opaque finances and little-understood acquisition record. It has its hand in an array of businesses—25 in all—including Thai auto leasing, global airplane leasing and one of the largest private-label credit card businesses in the world. And it doesn't break the performance of its businesses individually, but does so by sector. Though GE is known for its accounting compliances and is well regarded in the accounting circles for its financial statements, critics allege that GE Capital usually does not provide detailed information about an acquired firm's finances, the fate of their workers and the overall terms of the deals.

Managed earnings?

"We manage business, not earnings."

—Jack Welch

Ironically, GE, the harbinger of predictable growth, is under scrutiny for its predictability. In its consistent earnings for about 101 quarters, GE always had a loss in one division compensated by a gain in another. Take the case of the \$1.3 bn gain in 2000 when UBS AG (Union Bank of Switzerland) bought Paine Webber, in which GE had a large stake. This gain for GE was more than offset by one-time charges. The company routinely uses restructuring charges and one-time gains and losses to smooth out its earnings. Critics point out that it is very difficult to trace these restructuring charges and one-time gains within GE's financial filings. And because GE has excluded restructuring from its segment results since 1998, finding the effects of these one-time charges on GE's businesses becomes very difficult. Such complexities have led to investors' and analysts' demand for more disclosures. GE's consistency in double-digit earnings and almost yearly one-time charges has fueled the allegations of earnings management.

Critics are also scrutinizing GE's pension plan, which is over-funded to almost 75 percent, largely a result of the now dead, bull market. GE has mostly used them to cushion its bottom line when it could have distributed those gains to retirees. Little surprise then that pension is called GE's 13th business.

GE may not be alone in such practices but the accounting debacles at Enron and Tyco have increasingly made investors skeptical. GE, being a revered company, is the first and foremost target. Investors are demanding more information about GE's complex finances. And its remarkably consistent earnings, which once commanded a lot of respect, are now being questioned.

Wayman is of the opinion that GE's growth rate, as well as growth at other large companies, will slowdown due to the recession. Investors must realize that the double-digit growth rate posted in the late 1990s was not normal. 1995-2001 was a period of hyper-growth that occurred as a result of several factors, such as increased interest in the stock market by individuals, excitement and optimism about the Internet, and a period of stable to declining prices. GE may still outperform other stocks because of its structure, even though that growth may be three to four percent.

Size: How does it matter?

"Size is an advantage, not an impediment."

—Jeffery Immelt.

GE today is five times its size when Welch took over and its earnings growth has actually accelerated in recent years. To maintain these high levels of growth, it requires acquisitions, the bigger the better. Merrill Lynch has estimated that four percentage points of GE's 9.9 percent annual growth between 1985 and 2000 was a result of acquisitions. The pending acquisition of Heller Financial, at about \$5.3 bn, suggests that GE might well be heading that way because this deal is GE's second largest. But bigger deals have their own problems. The bigger the deal, greater the regulatory scrutiny, especially from unpredictable quarters like European Union in Honeywell's case. Big deals become more risky given GE's size, as there are very few companies that are able to meet GE's performance criteria and make a significant contribution to its bottom line.

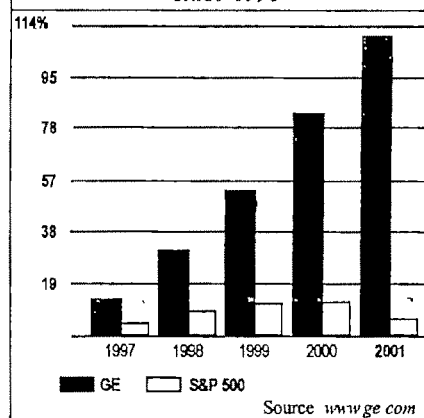
The bigger GE gets, the less likely its individual businesses are to outperform the market. A 15 percent earnings growth rate is not sustainable. At some point the sheer size of the company makes a premium growth rate impossible. Bronchick believes that "The acquisition-led growth strategy is unsustainable but not inherently stupid. The gross mismatch between the company's strategic goal and strategic reality is the rule of large numbers which forces GE to do larger and larger deals which have higher and higher degrees of risk."

Wayman says, "As a conglomerate, the strategy is to achieve diversification via being the number one or two player in each sector. Over the long haul, the "portfolio effect" should provide a steadier growth rate than being a single industry company. In addition, GE is way too big to have even tried to attempt to grow by acquisitions only."

Conglomerates don't work, but GE does

GE's fans always believed that GE is an exception. While they voice their skepticism over all other conglomerates, they laud GE. On one hand, GE's admirers believe that the world's largest company, measured by market value, is a unique example of strong earnings even in a languishing economy. On the other hand, critics see GE as a complicated industrial conglomerate that doesn't fully disclose the sources of its ever-improving

GE/S&P cumulative dividend growth since 1996



earnings (15 percent). Nor is it transparent about its accounting methods it uses to produce the results.

In response to criticism, GE Capital recently made a \$11 bn bond offering. It plans to sell about \$25 bn of long-term notes and bonds in the second quarter to reduce its reliance on short-term debt. GE plans to rebalance its portfolio with a little less reliance on commercial paper. Steps are also underway to increase bank line coverage.

Wayman thinks, "GE's strategy was to take advantage of declining interest rates and the yield curve by increasing short-term debt relative to long-term debt during the last year or two. If they needed funds, they issued cheap commercial paper rather than using long-term debt." This funding strategy is valid temporarily when interest rates are falling and the debt market allows such a strategy. But when GE realized that interest rates would probably increase in the latter half of 2002, GE started to lock in at the current low rates by taking on long-term debt and repay the short-term notes.

He adds, "Funding long-term assets with short-term debt is not a good idea in a rising interest rate environment, look at what happened to the US Savings and Loan industry in the 1980s. GE's switch was a timely strategy and a logical one."

The illustrious GE is under fire from investors and analysts and it seems to be warding allegations by taking some prompt actions. Whatever may be the outcome of this duel, one thing is sure—the days of privileged access to funding for GE are over. ■

Related Article:

GE: The winning strategies, *Analyst*, January 2002, Reprint # 1-2002-01-10

CSV Ratna, Team Analyst

Reference # 1-2002-06-02

BUSINESS ENVIRONMENT

EXIM Policy 2002-07

Implementation is the key

While the policy is designed to tap India's export potential, a lot depends on how the policy is going to be implemented.

With the dismantling of 50-year-old import restrictions, India joined the bandwagon of free world trade. It opened up a market worth \$25 bn under an Export-Import (EXIM) policy. A full-fledged effort seems to be under way to make exports an effective engine for growth for the Indian economy. The Government has decided to lift all Quantitative Restrictions (QRs) on exports, improve incentives for Special Economic Zones (SEZs) and schemes like Duty Entitlement Passbook (DEPB), advance license, and Export Promotion Capital Goods (EPCG) in the new five-year EXIM Policy 2002-07. For more information on QRs, refer our earlier articles of QR Phasecut—New Vistas and Competition vs. Protection in Analysis (May 2001).

Basically, the removal of export QRs, giving extra facilities to SEZs and boosting agricultural exports have been the mainstay of the policy. With the lifting of QRs, the policy has made a paradigm shift on its focus from import liberalization to export orientation. The apex business chambers have welcomed the EXIM policy and they say that the creation of SEZs would increase the flow of foreign investment.

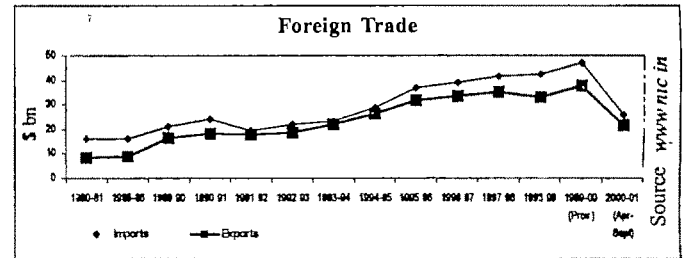
The most encouraging aspect of the EXIM policy is its focus in raising India's export competitiveness. Given the increasing global competition and the recognition that international trade is an effective instrument of economic growth, employment generation and, therefore, poverty alleviation, India has to build upon its existing strengths, create conditions for removing weaknesses, find ways and means to compete in the wake of the changing rules of the game and offer conditions conducive to meet the challenges. The new EXIM policy has aimed to address all these issues in a structured and comprehensive manner. The Union Minister of Commerce, Murasoli Maran, claims that the EXIM Policy is "comprehensive in scope and

multi-sectoral. It takes care of more than 80 percent of the population living in rural areas by focusing on the agricultural sector, cottage and handicrafts and small-scale sectors."

Targeting an eight percent GDP growth, the Commerce Minister says that the policy took "radical steps" in line with medium-term export strategy to fulfill the mission to capture one percent of the global share of trade by 2007, up from the present level of 0.67 percent. In real terms this growth projection will mean doubling the present exports of \$46 bn to more than \$80 bn over the Tenth Plan, requiring a compounded growth rate in exports of 11.9 percent. Maran says India lagged behind China in the export of items like toys mainly because they were reserved in India for the Small Scale Industries (SSI) sector and so he had no choice but to de-reserve them under the EXIM policy.

But exporters say the state governments could set the plans back if they fail to disburse credit and take other measures to promote agricultural exports. "The policy has laid emphasis on providing infrastructure for agro-exports and empowered states with more funds. Now the ball is in the court of the state governments," said Vijay Kalantri, president of All India Association of Industries. Agricultural experts have warned that removal of protection could hurt local producers of meat, fish, dairy products, spices, liquor, coffee and tea in the food category especially because many of these items are subsidized in the west.

India's scrapping of most export hurdles is a step in the right direction, but the Government's ambitious plan to snatch a one percent share in global trade by 2007 will depend on how the policy is



implemented. In fact it was almost five decades ago when India actually had more than one percent of trade share in the global pie. Unfortunately, despite emulating the Chinese success stories of SEZs, India's inconsistent policies that tend to shy away from reality has resulted in the shrinking of the share in global trade. A close scrutiny would reveal that most of the lost ground has been captured by our neighbors, like China and the South-East Asian countries.

Critics say that India's global trade has been shrinking in the last few months and there is not much hope of its revival in the near future. India's exports on the other hand have been disastrously falling. It is only a few weeks ago that the Government reduced its target of exports from 12 percent to 3 percent. The actual performance in the first nine months of 2001-02 has been just 0.64 percent. Most of India's sops have concentrated on the services, especially the IT sector. It is time to shift this focus on to agro-processed industries, which was mentioned as a major viable export earner only in the last budget.

What is now needed is a close monitoring of export growth and effective implementation. The rapid growth of exports achieved by China and South-East Asian countries has demonstrated that given the right policies and freedom from interference, we can ensure a sustained quantum growth in exports. ■

N Janardhan Rao, Team Analyst

Reference # 1-2002-06-03

A Tale of Two States



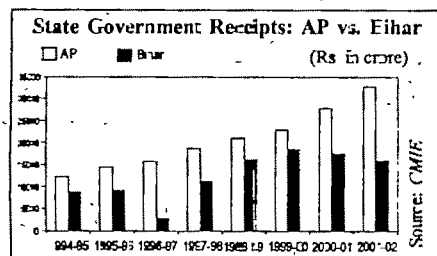
Two states—Bihar and Andhra Pradesh—one with a rich history and another, which is making one. The contrast becomes all the more palpable given the fact that Andhra Pradesh, for long an indistinguishable expanse on the map of India, is emerging as a contender for all that means progression. Bihar, on the other hand, with a repository of natural resources, continues to flounder earning negative encomiums. The creation of Jharkhand that has truncated Bihar has deteriorated the economy further. With meager natural resources and hardly any industries, there is little prospect for further progress. Gloom and despair is omnipresent. By contrast, Andhra Pradesh has paved its way to progress, trying to overcome all bottlenecks.

A TALE OF TWO STATES

Andhra Pradesh (AP) and Bihar present the two faces of modern India; while one is progressive, using information technology to chart its destiny, the other is economically backward and struggling.

Both the states have started their journey from a more-or-less similar socio-economic condition. Over time, however, they have traveled in significantly different directions. While AP has made substantial progress in terms of economic growth and development that has manifested in the form of increased purchasing power, specifically in the last five years, Bihar has lagged far behind. In fact, its pathetic state of affairs make it the poorest state despite its advantages from natural resources. What has been detrimental to the development or otherwise of these states? What are the factors that have been responsible to bring about growth in one state and those that have played havoc and reared economic and social upgradation in the other?

Bihar's journey dates back to the early years of the 20th century when the province was separated from West Bengal and established as a State in 1913. In fact, at that point of time, Bihar was better placed than AP. It had immense advantages in terms of natural resources such as huge mineral deposits (most of which are now a part of Jharkhand), extremely fertile soils, and ample rainfall. In spite of these resources, the state is in shambles economically and the general social and political indicators only reinforce the image of the poorest state in the country. It is still struggling with high fertility rates, low literacy rates, caste-ridden power politics and utter lawlessness. Today the image of Bihar as Sushil Kumar Sinha, ex-Secretary to the Governor of Bihar explains "...nowadays recognized throughout the world for its ugly face, ludicrous mentality and deplorable deeds, rape, murder, pilferage, fraud, bribe, scams, child-lifting, kidnapping for ransom, manufacture and transport of unauthorized arms, sale of skulls and bones, ...", the list goes on.



Pramod, Manager, Sahara TV, Patna, says that media hype is largely responsible for this bad image. He alleges that this hype is largely unjustified and incidents such as riots occur everywhere in the country. However, this is not the dominant opinion. Many feel that the state is actually in a very poor condition and attribute a number of reasons for this. Ajay Kumar, Editor of www.bihartimes.com sums up the causes for Bihar's backwardness likewise, "Lack of political will for development, bad governance, lack of basic infrastructure, very high dependence on agriculture, population growth rate being one of the highest in the country; People are cagey and try to hold on to whatever they have and society is highly fragmented on caste lines." All these factors contributed their bit to the deterioration of the state, which was aggravated by the lack of political will to improve affairs.

AP was formed through the combination of Hyderabad and Andhra region in November 1956. Since inception the state was never an outstanding name or attracted attention till the last decade. It was one of those states, which was not remarkable for anything till the liberalization process began. However, since then its growth process has changed greatly. Today AP is much talked and written about for its IT-driven strategies, e-governance, mobilization of funds, people-oriented programs such as DWCRA, mid-day meal schemes etc., among others.

Some symbolic representations of AP's economic development are visible in the capital city of Hyderabad. People residing here would ruminate that the city has undergone a sea change in the last five years. There are more opportunities, better facilities, better access to information, so on and so forth. Kyle Eischen from the Center for Global, International and Regional Studies and Department of Sociology, University of California, Santa Cruz, who had conducted extensive research about AP is of the opinion that, "AP has a combination of strong IT industry, facilitating government, extensive international networks and innovative local initiatives. ...it is both the combination and quality of these factors that distinguishes AP from many states within and outside India."

Liberalization and after

Indeed liberalization of the Indian economy has opened up new vistas for

"It is because of wrong policies that the divide between Bihar and Andhra Pradesh is so visible now."

*MV Sastry, Convener,
Center for World Solidarity,
NGO based at Hyderabad*

each state by allowing them to pursue their own growth strategy, negotiate for debt from institutions such as World Bank, initiate schemes that would encourage foreign direct investment etc. This relative freedom of state governments to chart their own growth path has been at the root of the major regional disparities that we see in Indian states today. While some states such as Maharashtra, Gujarat and AP have utilized the opportunity to put themselves on a growth mode some others such as Bihar have not really benefitted from this move. The New Economic Policy since 1991 has actually worked against Bihar bringing in more challenges than opportunities. Being a poor state even at that point of time, Bihar was not prepared for a market-driven growth.

AP, on the other hand, has gained from heightened awareness at the political level as well as amongst the people at large with regard to economic development. Jaya Prakash Narayan, Co-ordinator, Lok Satta, points out that this change in the attitude is a great leap from the past. He observes that earlier the obsession of the state and the media was 'political power' alone, whereas now there is a conscious attempt to improve the economic lot of the state. The Government's focus today is to attract businesses, educational institutions, best human talents etc., into the state. The persuasive skills of the Government are clearly visible in the fact that the Indian School of Business, which was initially proposed to be set up in Bangalore or Mumbai, was finally established in Hyderabad. There is no dearth of promotional activities undertaken by the Government; from shopping malls to various industrial exhibitions to cement its place in the minds of prospective

investors. In fact, the prestigious Asian Games (Athletics) 2002 is taking place in a newly constructed stadium in Hyderabad.

Private participation

The growth of AP has been led by state initiatives as well as participation of the private sector. In all spheres of activity, the participation of private entrepreneurs is high. In fact, many facilities and amenities in education, health etc., are in the hands of private entrepreneurs. Their presence is so prominent that without their role the sector itself would be jeopardized. The role of the state is limited to being the facilitator and a regulator, something akin to an incubator for budding private industries. Development expenditure of the state has gone up from Rs. 6331.8 crore in 1994-95 to Rs. 16047.1 crore by 2001-02, an increase of 153 percent in a short span of five years. Education and health facilities among others account for most of the development expenditure by the state.

MC Das, a Management Consultant and an academician also believes that the vision of the ruling parties and the attitude of the people of the state are primarily responsible for the progress of AP. The AP Government's efforts brought about considerable improvement in the infrastructure of the state. Basic amenities such as water, power supply, transportation etc., have all been improved to better cater to the needs of the people. The development of communication facilities in the state is a remarkable feature.

Education facilities in the state are widespread. There are a number of prestigious educational and research institutions in the state. They stretch from state sponsored educational institutions such as Regional Engineering College in Warangal to the recently established, internationally reputed Indian School of Business. The list of research institutions is also noteworthy beginning with Center

for Cellular and Molecular Biology, Defense Research Labs, Indian Institute for Chemical Technology, so on and so forth. Facilities for higher education in the state are also widespread and accessible to various sections of the society.

It would not be surprising to find that even in villages it is normal to have at least one highly-qualified member of the family who has settled abroad. The number of colleges has gone up considerably in the last four to five years. This move, some fear might dilute the quality. At the school level, however, private players lead the education system. State-run schools are not preferred by students and parents for various reasons such as lack of teachers and infrastructure.

Health facilities are a determinant of the quality and the productivity of human resource. In AP, however, there is a peculiar pattern. There is a boom in private health establishments and medical facilities all over the state. While the capital city of Hyderabad is dubbed as the medical capital of India, private entrepreneurs provide most of the facilities. The public health amenities are repressive because of the quality of the treatment. A look at the government hospital such as the Osmania General Hospital in the heart of the city is enough to deter most of the middle and upper class people from using its facilities. They are forced to seek private medical care. However, the poor with their financial constraints bear the wretched medical services of the government hospitals and are often destined to death. The private medical care facilities pose a different problem altogether. The prices are exorbitant but the general complaint is that most such hospitals recommend a number of unnecessary tests and examinations, which consume considerable time and money before any medication is actually started. In villages, the situation is worse. The public health centers are not sufficient to meet the needs of the population and in many centers doctors are generally not available. They are busy running their own private practices.

The condition of transportation in AP is far better than many states. Interconnectivity to the different districts in the state is high both by road and rail. The APSRTC (AP State Road Transport Corporation) uses a mix of its own and hired vehicles to service various routes in the states. The mobility of productive population within the state is also high. People do not find it a problem to live in

"Rise of iconoclastic leaders such as Laloo is because of democratic empowerment and not economic empowerment. So they don't have economic vision for development. They don't subscribe to the euro-centric model of development."

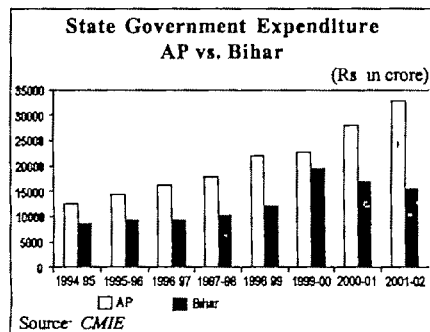
*Dr. Shaibal Gupta, Member-Secretary,
Asian Development Research Institute,
Patna*

one place and work in another. Well-established cities like Visakhapatnam, Vijayawada, Warangal etc., form the regional hubs within the state and cater to the needs of the population in the surrounding villages. Private entrepreneurs provide communication services such as telephones, cellular services etc.

Government initiatives

After liberalization one might argue that the state should be left to the invisible hand of the market forces. But to reap benefits to the maximum, this invisible hand of the markets should be guided by the visible arm of the state opines Dr Arif Waqif, Professor and Dean, School of Management Studies, University of Hyderabad. The AP Government has consciously embarked on an IT-driven growth model. Many reputed companies such as Satyam, Infotech Enterprises and Visual Soft are based at Hyderabad. Wipro and now Infosys, have also established branches in the city. Hi-Tech City, a sprawling establishment, which houses the likes of Oracle and Microsoft is located in Hyderabad. The number of IT businesses in the Hi-Tech City alone is 28. While software development is a considerably high-end job, there are many employment-generating activities in the lower end of the value chain. They include call centers, medical transcription, data processing units etc. Big business names such as GE and DE Shaw are the companies that have established shop in these sectors in the state. Such businesses absorb thousands of graduates who are produced in the state every year. In fact, they have become alternative employers to many, given the steady decline in government recruitment.

AP is making a leap from a rural economy to an information-driven



A TALE OF TWO STATES

model and is missing industrialization altogether. Today even in villages people are well aware of the programs of the Government. Much of the interaction between the Government and public has been shifted to the Internet. E-Seva, the government's initiative to shift governance from a brick and mortar business to a virtual business is proving to be popular. The entry and use of Internet has brought about a high degree of transparency in the business of governance. Impressive initiatives include a daily report to the Chief Minister about the state of affairs of various offices and programs. Videoconferencing with the collectors and other district level authorities has become a normal affair in the state now. Authorities are held answerable to their actions in front of peers and others. In essence, there is some conscious effort on the part of the Government to improve the quality of affairs in the state agrees Jaya Prakash Narayan.

Compared to many other Indian states and even the process of Government formation at the center, the democratic process in the state is much smoother. Elections at all levels of Government from the state, municipal to village Panchayats are a regular affair. Ecoth capturing and electoral violence do have a presence but within tolerable limits. Factionalism and caste-based politics is also comparatively less in AP. There are two major parties across the state but there is little difference in their ideologies. Both have high ambitions for economic development of the state. Dr. Waqif also believes that the opposition party in the state is not just obsessed with pulling down the ruling party but does acknowledge growth initiatives by the state. While that is definitely a part and parcel of the game, the opposition in AP has been largely supportive of the ruling party in its ventures. Dr. Waqif emphasizes that an active and healthy opposition acts as a process of checks and balances for the party in power.

Bihar: A Pandora's box

There is an intricately woven web of inter-related problems in Bihar, the

presence of which goes back to the pre-independence days. The fertile soil of the state and the abundant water resources of the state attracted the attention of the British and they plundered the state of most of its resources for decades together. This particular issue, many experts from Bihar contend, has not been the situation with the southern states about which the Britishers were hardly interested. In addition, Bihar has been a flood prone area. MV Sastry, Convener, Centre for World Solidarity, an NGO based at Hyderabad, comments, "Bihar is a highly flood prone area. Unless this is always kept in mind, what is happening in Bihar cannot be fully understood. About 16.5 percent of the flood prone area of the country is located in this state and 22.1 percent of the flood affected population of the country reside in Bihar." AP's coastal region was also prone to floods. But, flood control measures implemented with vigor have considerably reduced the devastating effect of floods and other natural calamities, which has not been the case with Bihar.

Dr. Ramji Sahai, Head of the Economics Department, Bhagalpur University, Bihar, observes that another significant factor is the allocation of plan expenditure for Bihar, which he claims was not as much as it was for other states including AP. Right from the first five-year plan till the sixth five year plan there is a great differential in the per capita plan outlay and per capital central assistance rendered to AP and Bihar.

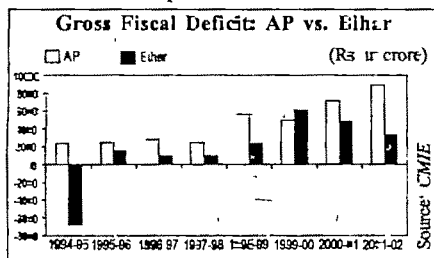
Shaibal Gupta, Member-Secretary, Asian Development Research Institute (ADRI), Patna, brings out an interesting fact about the attitude of Bihar toward national budget and their reactions towards the state budget. He observes that while CII and FICCI were putting forth their best case forward with well researched documents and chief ministers such as Chandrababu Naidu (AP), Prakash Singh Badal (Punjab) and Naveen Patnaik (Orissa) put all their political might for the best interest of their respective states, for the average Bihari politicians, national concern predominated, rather than the interest of the state. He points out that they never analyzed the national budget from Bihar's point of view. Announcement of new trains facilitated ferrying of cheap laborers from the state, subsidizing 'green' and 'industrial revolution' elsewhere. This indifference was not limited to the national budget but remains with the state's budget-making process.

"People and Government of Andhra Pradesh are talking and striving for economic development. That is a good change and though we are not doing as much as we should there is some initiative, some action that is being taken and that should be appreciated."

*Jaya Prakash Narayan,
Co-ordinator, Lok Satta*

Many members of both the intelligentsia and general public do not know much about the financial state of affairs. In Bihar, the assets have increased only at 13 percent while liabilities have increased at the rate of 20 percent. The deficit is hovering around 7-8 percent. The worst fact about the state's finances is that 89 percent of expenditure is dedicated to administration and interest payments. The debt burden of the state is at Rs. 35,000 crore as of 2000-01, which is 35 percent of the GDP of the state. For instance, out of a total budget of Rs. 18,503 crore in 1999-2000, an amount of Rs. 3,519 crore was spent on repayment of loans and interests (19.6 percent). Interest payments alone accounted for Rs. 2,825 crore (15.3 percent). Beginning with 2000, the expenditure of the state has been on the decline as well as its revenue.

In Bihar, the state budget has long ceased to be a charter for tackling economic problems. There is dearth of any active equity culture or investment in the state. The establishment of a stock exchange too did not do much to internalize 'developmental culture' in the state. The lack of 'developmental literacy' as Gupta points out led to the acceptance of the 'freight equalization' policy. After 1950s, freight equalization was introduced which spelled doom not only to Bihar but also to Bengal. Freight equalization meant that whatever goods (steel, coal, cement etc.) were transported from Bihar, the transport price will remain unchanged. This policy was primarily aimed at subsidizing Indian industrialization. In the process, transportation became a costly affair in Bihar. With this policy, industries for which Bihar should have been the natural home have shifted elsewhere. This was not introduced for other areas in the country.



Gupta claims that "there has been a deliberate policy of the national government to deprive and to economically disenfranchise Bihar through national policy instruments." Bihar's intelligentsia reasons that with a shift in the political focal point from Eastern India to Western India, the national policies reflected the interests of Western India.

Industrial growth, not quite

The rich mineral deposits in the state attracted many an industrialist to set up shop there. During the 1960s, the rate of industrial growth in Bihar was on par with that of India at five percent. But that early momentum did not sustain throughout. By the 1980s, India's industrial growth was picking up at the rate of eight percent while that of Bihar was on a decelerating trend. This decline was at the root of the subsequent economic deterioration in the state. Large industries in Bihar kept up with the growth in industrialization at the national level since their products were marketed across the nation. However, small industries in the state did not develop because they were dependent on the slowly growing local economy.

There are certain structural problems that have caused this scenario in Bihar. Firstly the poor state of infrastructure, particularly weak power availability. Another constraint to industrial growth has been the absence of home market, which is crucial. The state, with its traditional agriculture did not have adequate supply of capital. The per capita agricultural income of the rural population is much below the national average.

The socio-economic situation of the state only went from bad to worse after liberalization. The causes are many. Gupta points out that an important cause for the lack of economic development in the state has been the sub-nationalism issue. His research reveals that while people in most Indian states have a strong feeling of being an Indian and then that of

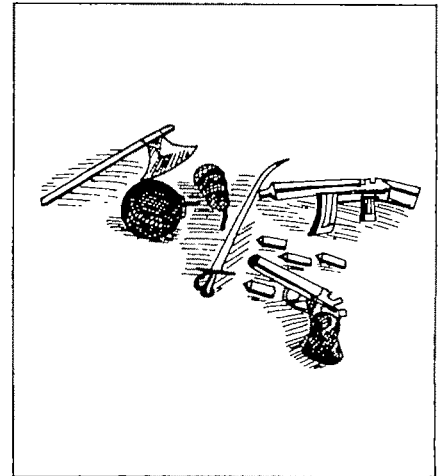
belonging to their particular state, in Bihar there is no such positive feeling. In most cases, it is limited to belonging to a particular caste. This feeling is much more than what they feel for the state thus limiting their vision for development to their own caste. Most educated and able people from Bihar seek opportunities elsewhere. This brain drain has further contributed to the deterioration of Bihar.

'Cast(e)'ing an effect

One problem that has had an all-pervading adverse impact on the state of Bihar, is the 'caste' feeling. Caste is a widespread phenomenon across India but the magnitude of its impact is very high in Bihar when compared to other parts of the country. Coupled with crime and petty politics caste has become a lethal weapon for the development of Bihar. Observes Ajay Kumar, "Casteism, crime and politics have virtually proved a major deterrent to the process of development in the state. The spurt in crime, particularly abduction of businessmen and subsequent collection of heavy ransom from them, forced many of them to leave this state. In some areas, businessmen pay a tax to the local dons for carrying on their businesses."

Even to this day incidents of violent attacks and counter attacks in the name of caste are a normal phenomenon in Bihar. There are a number of historical reasons for this. The abolition of the Zamindari system has not had any positive impact on the fate of the landless and the Dalits in the state. 'The Green Revolution' and the subsidies given by the state has reaped benefits only for the landlords and the land reform yielded gains for the upper class tenants.

In villages, the upper caste people generally control most of the land and the land reforms could not do much to decrease this concentration. Wherever there has been some equitable distribution to the lower caste people, statistics indicate that landlords use tactics to ensure that the land is returned to the landlord. It is alleged that Ranvir Sena, a private army of the landlords and such other forces burn the crop after a harvest. This would leave the poor and marginal farmers with no other option but to borrow money when the time to sow the seeds comes by. In a desperate position, they are forced to mortgage their land and other properties to the landlords, who are rich and incidentally belong to the upper caste. Once land is mortgaged, the chances of the owner retaining

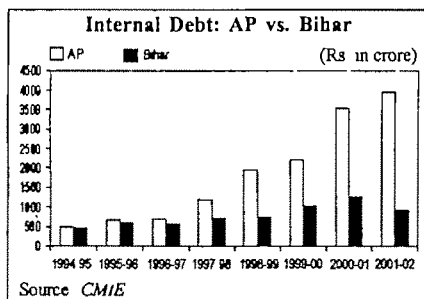


control over it are almost none. This further adds up to the poor economic status of the lower caste people. Farmers, who once owned acres of land, have become landless today owing to the wheels of oppression and severe casteism.

It would not be an exaggeration to say that these caste differences are also at the root of the violence perpetuated in the state. It is the army of one caste fighting with another; generally one of the parties is an upper caste while the other belongs to a lower caste. The pent up frustration in most of these classes comes out in violent outbursts against each other. This has led to an absolute lack of law and order in the state.

One of the main reasons that is attributed to the utter lawlessness that is rampant in Bihar has been the inefficiency of its police force. The effectiveness of the state's police force has been on the decline for some time now. PC Biswas, Retd. senior officer in Indian Railways, points out that the menace of landmines targeted at police vehicles is so high that people do not dare to travel anywhere in the vicinity of these vehicles on the road. Some years ago, people would have followed the police vehicle considering it an assurance of safety.

Another thought-provoking factor is the minimum educational qualification for constables. In Bihar, the minimum qualification required for a constable is at present only Standard VIII reduced from the erstwhile requirement of metric. This has attracted a lot of flak from the media and the Government has been rebuked by Patna High Court. Constables are the ones who are directly involved at the point of crime and a less educated person gets swayed away by the caste effect which makes the objectivity of police and law enforcing agencies meaningless.



A TALE OF TWO STATES

A Visitor's Account

Researching for the cover story on the comparative economic analysis between the states of Andhra Pradesh (AP) and Bihar brought me to the Howrah Station, well ahead of time. From here, I was scheduled to board the Danapur Express (departure time: 9:05 p.m.) for Patna, the capital of Bihar. The platform was a typical one: Noisy and overcrowded with several long queues, each consisting of more than 300 passengers. They, I understood, were supposed to occupy the general compartments of the train, where no seat reservation is required. There were hardly four general compartments, two adjacent to the engine and two at the end of the train.

I had a second-class reservation and anticipated that, at least I will be escaping the pressure of this surging humanity. However, shortly later, I was proved wrong. People who could not accommodate themselves in the general compartments, entered the reserved compartments. Even the vendors who found it difficult to place their wares in the general compartments, boarded the reserved compartments. Flustered, I asked one of them as to why they were crowding the reserved compartments when they have been allotted separate vendor compartments. The answer was, "In what way are we harming you? Go and mind your own business. We will put all these things in the aisle between the two bathrooms and not on your seat. Do you understand that?" I asked, "Then how do we go to the bathroom?" He answered, "You just boarded the train. Why do you need to go to the bathroom, now?" It was futile to argue any more.

I was allotted a side lower berth. However, it was fully occupied. Neither was there any place to sit nor was I left with any space to keep my luggage beneath the seat. Others had already occupied the space. Here it was more on a 'first come first serve' basis and not on the basis of reservation. When the train started, I soon understood that a reserved compartment in a train headed towards Bihar is no better than the general compartments. As the train chugged along, I ruminated on the train journeys, which I often undertake from the twin cities of Hyderabad and Secunderabad. The orderliness which went into the act of boarding a train, easily finding the allotted berth and then settling down for the journey ahead seemed to be a natural progression of events. The rights of other co-passengers were not to be tampered with unlike the fate to which I was subjected to now.

It was late in the night when I was finally allowed to sleep, as people gradually started detraining. The Traveling Ticket Examiner (TTE) never appeared when the train was over-crowded. But at midnight he appeared, not with the intention of checking tickets but to explore the opportunities of allotting empty berths to potential candidates, in lieu of exorbitant charges. This money will not go to the Railway department but into their capacious pockets.

Early morning at around 5:30 a.m., I again found the compartment crowded and was squeezed in by three students. Their intention was to wake me up so that they could sit comfortably. But I pretended to sleep and ignored them. Listening to their conversation, I understood that most of them were intermediate students. Every day they travel around 50 to 60 kms by train to attend classes. This explains the state of the education system in Bihar.

The train mercifully reached Patna on right time; i.e., 8:20 a.m. I had a friend at Patna, Prabudha Biswas, who is working there as a journalist in *Hindustan Times*. I had contacted him earlier and informed him about my visit. In Patna station, I started hunting for a telephone booth. I found one but again there was a long queue. I was supposed to call my friend, and inform him about my arrival. Waiting for some time and not getting a chance, I went to the main road in search of a booth. I found one and dialed his number. Unfortunately, a recorded message came through, "All lines are busy, kindly call after some time." I called again. Only to hear another message which said, "The number you have dialed is temporarily disconnected due to non-payment of bill." I was surprised. Just one day ago when I called from Kolkata, the line was clear.

However, I walked towards the bus stand. I had to go to Rajendranagar. To my utter surprise, there was not a single state-owned bus in the stand. However, there were a few private buses, all of which were destined to the outskirts of the city, with very limited buses providing service within the Patna city. The condition of the buses was pathetic; there were no seats and the metallic frames of the seats were flimsy; the floor and the sides of the bus were splattered red, with the remains of betel leaves; and there were no windows altogether. Even the condition of the bus stand, which was actually a small field, was dismal. There was a garbage dump next to the stand and the whole area was covered with a pungent smell. And this was the main bus stand in the city, adjacent to the railway station with all its importance. Once again the dissimilarity between the two states struck me. Looking back, I believe I took the transport department of AP for granted. There the interstate and interdistrict connectivity was admirable and passengers actually had a choice of buses to undertake their journey based on the price. Metro liners which ply within the city were costlier but faster compared to the regular city buses. Interstate buses could be classified as AC or non-AC with even sleeper berths available on some routes.

Shaking of the gloom, I took an auto-rickshaw and asked the driver to take me to Rajendranagar. Autos ply with neither any fixed charge nor do they have any meters. He asked me Rs. 50. As I never went there before, I thought it better not to bargain with him. After reaching my friend's residence, I complained that his phone was not working and that I had to hunt for his house. My friend outrightly denied this and immediately proved that the phone was functioning! Later, when I asked him about the transportation situation in Patna, he said that previously there were

state buses covering Patna, rest of Bihar and connecting other states as well. Gradually as private players were allowed to operate, they damaged all the state buses to increase the profit margins.

After taking some rest I went out to visit the market along with my friend. I met Rajesh Singh Akali, a renowned merchant of cosmetic and imitation goods. After introducing myself I asked him about the business environment in Patna city. He started with the riot that broke out in 1984 after the assassination of Indira Gandhi. More than 75 percent of the Punjabis and Marwaris left Patna and settled in parts of Maharashtra, Gujarat and Bengal. This not only had an impact on the investment scenario in Bihar but also affected the aggregate consumption expenditure of Bihar. Punjabis are known for their high propensity to spend. According to Rajesh, they spend 60 percent of what they earn, save 20 percent and donate the rest.

Other businessmen of Patna opined that the Ramjanmabhumi-Babri Masjid issue that created a communal riot deteriorated the situation even further. Relatives of the Chief Minister, allegedly plundered shops and commercial places, created terror, alienating the existing business community from Bihar. This also had an adverse impact on the small entrepreneurs and investors. The plundering of shops, according to the businesses at Patna, takes a new dimension before the votes. Guided by the ruling party, the plunderers (locally called *Rangdars*) loot the shops for blankets and clothes, to distribute among the poor and easily become their 'Godfathers'. According to the people in Patna, the politicians create the *Rangdars*, for their political and physical protection. Once their purpose is served they destroy the power of these plunderers, as well. Even the CM's daughter comes to the jewelry shops and selects jewelry worth lakhs of rupees without bothering to pay a penny. Rakesh Jain, a jewelry and cosmetics merchant says, "Tension is omnipresent." He adds, "I work hard the whole day to earn money and if I have to sacrifice a considerable amount from that to the *Rangdars*, how do I survive?"

The situation of schools and colleges is even more precarious. There are several schools and colleges, which though reported in papers, are practically non-existent. In most cases, teachers are recruited on the basis of caste, muscle power, and bribery. A scenario that is in great contrast to the one prevailing in AP. Schools and colleges offering different career courses abound in the state. Educational facilities are widespread in the cities and the villages equally. However, the private establishments score more heavily compared to the government-based institutions.

In Bihar, the government job vacancies have decreased drastically, and to get a government job is akin to a miracle. No industries have emerged in decades and the existing companies are in shambles. Rural Bihar presents a gloomier outlook. With the land ceiling being implemented to some extent the landlords (locally known as *Bhumihars*) lost lot of their land. The landlord class created the Ranvir Sena to fight for their lost land that has been redistributed among the poorer sections. The frequent incidents of killings of innocent Dalits and member of their families by the Ranvir Sena are only to capture the lost power of the *Bhumihars*. This is again a never-ending battle in Bihar. Says Mukesh Yadav, of Dira village, 10 kms from Bhagalpur town, "Only the brutal killings of innocent people appear as news headlines in newspapers, but seldom do the outside world come to know about how the Ranvir Sena destroys matured crops or starts a fire in a paddy field." After the harvests, they spend the whole money earned either to repay the past borrowings or to meet some essential requirements. And again they borrow for the next season to buy seeds and fertilizers leading to a never-ending debt-trap.

Though I had an appointment with a person in Bhagalpur, a town approximately 200 kms from Patna, he was busy in some other meeting. Since I had the time, I entered a cinema hall close to the station to watch a Hindi movie. Entering the hall, I understood why the entertainment industry could never take-off in Bihar. The walls and the floors of the cinema hall were splattered in dirty hues of red; remnants of betel juice and other chewables like *Gutka*. However, as I had already bought the ticket and wanted to watch the movie, I occupied my seat. A well-dressed person took the seat next to me. Expecting this person to be different from the usual crowd, I was disappointed, as this person also went on a spitting spree! Insects making a feast of my feet compounded the dank atmosphere and I had to exit the cinema hall midway. Coming out, I again contacted the concerned person, but he was still not available. By then it was evening. Electricity went off the streets, which were relatively empty. The power returned around 8 p.m. But what an irony it was! The voltage was so low that I could not even see myself! To get a voltage of 60 watt, one has to use a lamp of 200 watt. On enquiring, I realized that this was nothing new and it was a daily affair.

Next morning I went back to Patna. In the evening I had to catch my train to Howrah. A senior ex-government official had written something for me regarding the misery of Bihar. However, he wanted to give me only the photocopy and not the original. It was already evening by then and my train was scheduled to depart at 8:45 p.m. I was frantically hunting for a photocopying shop where I could get photocopies of his write-up. Being a heart patient, the senior government official could not rush along with me. In the meantime, the power went off as usual leading to a total chaos. Ultimately after hunting for about 40 minutes I located a shop and got the material photocopied. (In most other states, STD booths and photocopying shops are ubiquitous in their presence!) Then I rushed to my friend's place, had food and somehow made it to the train. The train scenario was alike. I did not get an opportunity to sleep the whole night and neither did the TTE visit our compartment.

- Debasis Mallik

A TALE OF TWO STATES

Wooring Wealth	
Bihar	Andhra Pradesh
• Subsidy of up to 15 percent of capital investment for new small and ancillary industries.	Investment subsidy 20 percent of capital cost subject to a maximum of Rs. 2 mn for industries to be set up in Area I and 15 percent of capital cost up to Rs. 1.5 mn in Area II and III.
• Additional subsidy of 10 percent, up to Rs. 1 mn, for purchasing energy conservation equipment.	Additional investment subsidy @ 5 percent of fixed capital cost up to Rs. 0.5 mn by AP Industrial Infrastructure Corporation (APIIC), at its under-occupied industrial estates.
• Sales-tax deferment and exemption for finished goods.	Investment subsidy 20 percent of fixed capital cost subject to a maximum of Rs. 2 mn for captive power plants up to 1,500 KVA.
• Power subsidy of 18 paise per unit for units with capital investment of up to Rs. 7.5 mn.	25 percent rebate on power bills for three years, upto Rs. 5 mn (large-and medium-scale) and Rs. 3 mn for small-scale industry.
• Power subsidy of 15 paise per unit for units with investment of between Rs. 7.5 mn and Rs. 150 mn.	Sales tax exemption, of 100 percent of fixed capital, or Rs. 3.5 mn, whichever is less for tiny and small-scale sector for a period of five years.
• Subsidy of up to Rs. 0.01 mn for modernization and productivity improvement by SSI units.	Sales tax deferment, equal to 135 percent of fixed capital investment over a period of 14 years or seven years sales tax exemption.
• Special facilities for Scheduled Caste/Scheduled Tribe and technically-qualified entrepreneurs on priority basis.	Special incentives for new small-scale units set up by Scheduled Caste/Scheduled Tribe entrepreneurs (25 percent of capital cost or Rs. 2 mn in Area I, 20 percent of capital cost or Rs. 2 mn in Area II and III)
• Feasibility study subsidy of up to one percent of fixed capital, or up to Rs. 0.02 mn of SSI units.	The total credit i.e., Term Loan and Working Capital components is eligible for reimbursement of interest subsidy @ six percent for a period of five years up to a maximum of Rs. 0.1 mn per year for Areas I, II and III.
	Free pre-shipment storage and low tariffs for units in Visakhapatnam EXIM Park.
For the purpose of incentives, Andhra Pradesh has been grouped into three areas which are as under:- Area I : Srikakulam, Anantapur and Adilabad districts. Area II : Nalgonda, Mahabubnagar, Warangal, Kamam, Medak, Karimnagar, Nizamabad, Kurnool, Cuddapah, Chittoor, Nellore, Vizianagaram and Prakasam districts. Area III : Visakhapatnam (except Visakhapatnam Municipal Corpn. Limits), East Godavari, West Godavari, Krishna (except Vijayawada Municipal Corpn. Limits) districts, Guntur, Ranga Reddy and Hyderabad (except Hyderabad Municipal Corpn. Limits) districts.	
Source: Indian Investment Centre	

Little wonder then that crime in Bihar is on a one step short of outright looting and plundering in broad daylight

Missing 'Governance'

The role of the state in achieving economic development is conspicuous by its absence in Bihar. The leaders of the state are obsessed with safeguarding their power and making quick money rather than attending to the problems of the state. They are more concerned (and

scared nowadays) about who is going to be caught when and for what scam and are busy devising clever schemes to avoid detention by the court of law.

At the level of municipalities and Panchayats the situation is even worse. Bihar has never really come into the fold of these local self-governing bodies. Panchayat elections were held in 2001 after a gap of 21 years. Patna Municipal Corporation (PMC) polls were conducted after a gap of 18 years.

Not one but all the facets of the state are in a poor shape. Dr. Buddhadeb Ghosh, Professor, Humanities and Social Science, IIT Kharagpur, makes an interesting observation, "Beyond the immediate short run, education is the most important tool at the hand of civilized people to help evolve the society in a desired direction." He further comments that in Bihar "like all other sectors, education is also one of the most corrupted areas ... continuous flight of

intelligent (and visionary) people because of short-run chaos and corruption has always eroded any possibility for future hope. Even a cursory look at state-level statistics would make this clear." As of now, there are 37,366 primary schools and 7,764 middle schools in Bihar, resulting into a middle to primary school ratio of 1:4 as against the national ratio of 1:2

Education in Bihar is a big farce. JM Prasad, ex-Inspector General of Police of Bihar avers, "There is no identification in examination halls. Anybody can answer the paper and the answers were read out in the loud speakers." He goes on to observe that, "Now a district judge is to supervise and some discipline has been restored. High Court is right now intervening in executive actions of the state such as asking for the cleaning of drains etc. Things to be done by executive easily are being forced by the High Court. Because the executive is not able to discharge its duties the judiciary is intervening."

Commenting on the education system RN Chowdhary, Ex-Vice-Principal, Ranchi Polytechnic College, bluntly observes that there is no future for the polytechnic institute. He further supports this argument as he mentions that no funds are sanctioned for updating laboratories, libraries and courses are not job-oriented but so outdated that no company comes forward to recruit the students. JN Chowdhary, an employee of Ranchi University reinforces this image as he mentions that there has not been any increment in 10-15 years. In fact salaries are irregular by three to four months.

Transport travails

The transportation in the state is in a rather bad and unusable shape. One of the reasons for the bad state of affairs in the inter-state and inter-city road transport in Bihar is indiscriminate privatization. Today virtually there is no public transport that connects regions within the state or within the city. Medical facilities and health care too are in shambles.

Bihar's problems only get complicated by the separation of Jharkhand, which took away most of the industrial establishments with it. Now Bihar has been left bereft of the industrial giants established during the good old days of public sector industries. The present scenario in Bihar has made it an unattractive destination, if not a nightmare, for investors from outside

Bihar thus further minimizing its chances of becoming an industrial center. The lack of minimum security to the property has been a real de-motivating factor for the enterprising spirit in Bihar. The experiences of businessmen in Bihar are no short of a horror story. There is very little security for the businessmen and employment generating activities. The law and order situation is so bad that people generally do not venture out of their homes after 6 'O clock in the evening.

Corruption everywhere

Add to the above the problem of corruption. Though this is a major problem throughout India, Bihar has paid a heavy toll for it. Gupta says that there are two schools of corruption—the Indonesia school and the Philippines school. As per the first school, money extracted through corrupt practices is invested in the same place whereas in the second school money is extorted from one place and invested in another thus ensuring a flight of investment capital from the state itself.

In Bihar, the Philippines school of corruption is dominant. This kills the spirit of the competent and in the long run has a detrimental effect on the state's welfare. The numerous scams that have come to light in Bihar such as Fodder scam etc., prove beyond doubt that corruption is a part of the administrative machinery in the state.

While AP is not free from this, its model is different. In AP, the Indonesia school of corruption is dominant. Thus though money changes hands at the individual level it does not leave the state. So in some way or the other it is the state that is ultimately benefitted, though in a unjust manner. Most of the money appropriated through this route is again channelized into different sectors for further investment. This again places AP in an improved platform compared to Bihar.

The other side of AP

The state of affairs in Bihar is depressing but that of AP is not as rosy as the state would want us to believe. Power tariffs in AP are one of the highest in the world. The state faces an immense debt burden. A keen look at the revenue and expenditure figures of AP brings out clearly that the Government's revenue expenditure is much more than its income. This has led to the increase in the total debt undertaken by the Government. Funding from institutions

"The case of Bihar must be made a common issue at the India level by all like-minded people irrespective of caste, creed, religion, politics and statehood."

*Dr. Buddhadeb Ghosh, Professor,
Humanities & Social Science,
IIT, Kharagpur.*

such as World Bank is very high. Between 1995-96 and 2000-01 fiscal deficit went up from 3.06 percent to 5.41 percent of the GSDP (Gross Domestic Product of the State). During the same period public debt increased from 18.96 percent of GSDP to 26.09 percent. Interest payments are to the tune of Rs. 5066.8 crore in 2001-02. There has been a constant rise in Government expenditure, fiscal deficit etc., since 2000. One reason that is attributed for this raise in the public debt is the Fifth Pay Commission recommendations, which have increased the expenditure of all the Indian states. When inquired if this high debt burden would be a hindrance to the future growth of the state, MC Das was optimistic that, "When the debt is for an investment and that investment yields income, it wouldn't be a burden either to the state or to the individual. The investments made, with the borrowed funds, on roads, communication, power-generation etc., will yield good results in the long run."

Economic development is not as widespread as it is expected to be in AP. While some areas are prospering fast, some others are still lagging behind. Jaya Prakash Narayan alleges that nothing has been done to improve the coastal areas, which are the engines of growth. The coastal parts of AP and the most fertile soils in the state have not really witnessed any developmental measures from the state. In the Telengana region, the problem of naxalites is still reigning strong. In areas such as Warangal and Karimnagar, where the naxals have a stronghold, people do not venture out of their houses after 8 or 9 p.m. If a red flag is planted in a field it is an indication that the naxalites have taken that land. Brutal killings of politicians as well as innocent people continue in these regions. The

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efforts of the Government to talk and rehabilitate naxalites are yet to meet with much success.

Experts feel that AP's IT-driven economic model might not be sustainable in the long run. Most of the jobs presently undertaken are at a fairly low end and unless there is a shift to value added products sustaining this growth would be difficult. Dr. Waqif too emphasizes that there has to be a change towards value added products as well as increased emphasis on developing hardware and other products rather than doing back end servicing.

Many people question the thrust on the IT-driven economy model that is presently the state's hallmark. Eischen rightly weighs the pros and cons, "...its important to point out that while there's no guarantee that AP will be fully successful in its new development path, it is at least attempting to find the right solutions.

He further points out, "...there is no packaged solution yet or well-established development model. 'IT for development' or 'information economies' are really being defined in the moment. ... AP is one region trying to work out a solution. There will be mistakes and failures; but the benefits will also come sooner."

The quality of life of the common man in AP has improved on certain grounds and has deteriorated on others. For instance, the pollution levels in Hyderabad are one of the highest in the world. The death of cotton farmers remains a scar on the state's image. However, there is general agreement among the intelligentsia and common man that the Government has become more responsive to the problems of the state than it was a decade ago. Dr. Waqif further believes that AP Government is on the path to the Singapore government's attitude of treating citizens as customers.

Advantage Bihar?

Is there any hope for Bihar? Answers vary. But one persistent response is that the center should come forward to help the state. Some such as Ghosh, do not see any light for the state unless the case of Bihar is made a common issue at the

national level. A similar solution is suggested by Sinha who firmly believes that the condition of Bihar needs special status from the Center for the sake of its development and there should be relaxation in the rules and regulations so that concealed wealth is unearthed. Some others argue that the Center should be pressurized to accord preferential treatment to Bihar for its historical legacy of backwardness. All these arguments though seemingly logical at the first sight do not offer a permanent solution. For one how long will the Center continue to pump funds into the state? The Center is in no position where it can pump in millions of rupees to uplift states backward or otherwise. Another important thing is that such support would act as an incentive for the state to remain weak and in fact encourage other states to drift into a state of economic backwardness. Though this might give some respite to the state it is not the right solution in the long run.

Some others such as Prasad squarely blame it on the political leadership of the state, Rajagopalachary, in his diary in 1934, written in jail says, "Many years after independence, a day might come in India when corruption will be galore. Churchill's comment that India is being given in the hands of men of straw sounded far-fetched at that point of time but now it is true that men of straw have come to assume power." The political leadership of the state especially under the reign of Laloo Prasad Yadav and

his wife has driven it to nowhere. Gupta avers, "It is ironic that a man with such a limited vision, without any achievement to his credit should continue to control the destiny of the state unchallenged." The fact remains that leadership is an important factor in the success or otherwise of any venture and this is true in the case of the state also. The AP CM, and his style of working of bringing about transparency in the governance of the state has won applause from one and all. In fact his leadership is most often cited as one of the main motivators for investing in the state. He is considered adept at performing his duties as the chief minister of the state.

Education is one key area that is an absolute necessity to grow out of this circle of economic disparity. Education of the masses of Bihar would go a long way in bringing about the necessary changes in the social structure of the state by improving the understanding and awareness of the people at large. Commenting upon curbing lawlessness, Prasad is of the opinion that the loot and dacoity in Bihar can be controlled if officers such as the influential KPS Gill and JF Ribeiro take charge of the state. He is optimistic that Gill's experience of curbing violence in Punjab could be replicated in Bihar too.

Transparency in the financial affairs of the state is another area where many suggest improvement. Gupta suggests transparency in the financial affairs of the state. People would not mind paying taxes provided the system delivers on the promises. Rather than a tax less budget to give a false sense of well-being and security, a budget that imposes taxes coupled with a government that uses the taxes to improve the state would be a better option. He further comments that with its abundant water resources, fertile soil and quality human resources, Bihar, could be brought back as a force to reckon with.

Given the fact that Bihar is predominantly agrarian, an economic policy that would bring about structural reforms in agriculture, which creates both investible surplus and market for local industries by increasing the purchasing power of people should be formulated. At the same time improvement in the overall budgetary position along with optimal deployment of the same for improving the industrial infrastructure is a necessity to put the state on a growth track.

The vastness of India makes it almost impossible for all the various states to grow at a similar pace or using a similar model. But the agony with regard to Bihar is that a state that was once better than its counterparts has fallen behind since 1971. Its problems can be minimized if not eliminated only with the help of a strong political will and social enlightenment. ■

DG. Prasanna, Debasis Mallik and
Rajesh Kumar Singh, Team Analysts

Reference # 1-2002-06-04

Indian Insurance Sector

Yet to evolve

The Indian insurance sector is witnessing a slow and steady change. Though the sector is yet to come out of the Government control completely, the new entrants are hopeful of competing head-on with the state-owned monopolies and create a niche for themselves.

The Indian insurance industry which until now was a controlled sector, with only two players for the last four and half decades, has suddenly turned itself into a battleground. Though the sector remained in the strong clutches of the government enterprises, the growth has been slow. The industry is characterized by a number of players, both domestic and international, competing for the huge untapped market. Indian insurance is ranked 51 in the world with a low insurance penetration of 1.95 percent and less than 5 percent being spent on insurance out of the available 22 percent savings. This low penetration and huge growth potential has already attracted many multinational insurance giants like Allianz, Royal Insurance, etc.

Big market

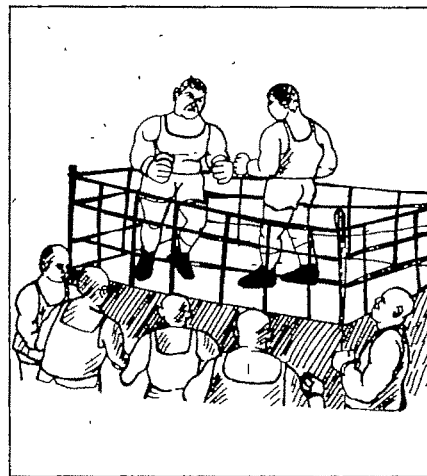
Today global insurance companies see only two countries having a great market potential. Incidentally both the countries, China and India, have a high population and relatively high savings rates. Though the savings rate hovers around 25 percent in India, less than 5 percent is being spent on insurance. In spite of the high savings rate, owing to poor reach and consumer awareness, the insurance sector has not grown that fast as anticipated. In spite of the fact that there are two government enterprises taking care of life and general insurance, their contribution to the gross domestic product is less than three percent. This only indicates the extent of growth potential of this sector in India. Despite the monopolistic control over the market by Life Insurance Corporation (LIC) and General Insurance Corporation (GIC) and its four subsidiaries, market

penetration has remained low especially in non-life insurance business.

However, the life insurance business has witnessed considerable growth because of the increasing customer awareness and better marketing strategies by LIC. In the last two decades, the number of nuclear families both in urban and rural areas has gone up, leading to increased need for life coverage for the breadwinner and this has resulted in a moderate growth of business. However, low consumer awareness still prevails in the non-life segment. Non-life business today can be attributed to the statutory requirements being laid down by the Government. For example, motor vehicle insurance is compulsory at the time of registration of the vehicle. But most of the owners do not renew it whenever it expires unless the vehicle is being used for commercial purposes. Perhaps the monopolistic status of the insurers is one major reason for low penetration in this segment. In the absence of competition, the government entities did not bother about developing the market and were content with the business they were getting.

Most of the private insurers are highly attracted by the large middle class population of 200-300 million who are becoming increasingly sophisticated

With a population of more than one billion, the Indian market is no doubt one of the biggest markets in the world. Though the sector has been opened for private participation just a year ago, it has already witnessed a severe competition among the players. With the opening up of insurance sector, there are presently around 12 life insurance and 10 general insurance companies operating in India with more players expected to come in. Most of the private insurers venturing into the sector are highly attracted by the large middle



class population of 200-300 million who are becoming increasingly sophisticated and are demanding new products and services.

Referring to the untapped potential of the market, B Anand, CEO, Bimaonline.com says, "India being a country of one billion people with low insurance penetration of 1.95 percent has a vast potential to be tapped. And the fact that only five percent of the total 22 percent savings being done through insurance sector, confirms that the industry will continue to grow rapidly for some more years." This statement only confirms the belief of many new players in the industry. Added to this, India's insurance penetration level is around 1.95 percent as against the global benchmark of six percent. Going by this rate, it has the potential to grow. New entrants find insurance attractive because even a small share of a large and growing market can be profitable.

The total market in life insurance was worth about Rs. 20,000 crore in 1998. The growth rate of this segment has been around 12-13 percent. If these growth rates are sustained, it is estimated that the market would grow to nearly Rs. 60,000 crore by 2008. However, the

INDIAN INSURANCE SECTOR

Confederation of Indian Industry (CII) has estimated that the market would grow to more than Rs. 130,000 crore by 2008.

On the other hand, the general insurance or non-life market is not that big as life. It was around Rs. 8,000 crore in 1998. Taking into account the same growth rates as that of life, the market is expected to grow to around Rs. 40,000—50,000 crore by 2008.

According to an industry observer, the biggest potential lies in the rural insurance market where the penetration of the government enterprises has been low. Often in rural areas, insurance is perceived as an additional burden rather than a means to combat risk. According to an independent survey conducted by a big private insurer, 20 percent of the rural population has an insurance cover. Considering the fact that 65 percent of the Indian population live in the rural areas, the market is highly attractive. Traditionally the insurers have not found rural insurance attractive. Opines Anand, "While most of the insurers may find it unattractive to tap the rural insurance, it should be understood that in the rural areas, the policies will be of relatively smaller amounts, but this will be compensated by a larger number than in the urban areas. Rural insurance should be looked upon as an opportunity and not an obligation. It is important to take advantage of the immense potential that resides in the rural sector."

Survival tactics

With the entry of new players in the sector, the competition has increased manifold. Giants like State Bank of India, HDFC, ICICI, Bajaj, and Reliance have all forayed into the market. Recently the Indian car giant, Maruti Udyog, also announced its plans to enter into insurance. Though the companies are competing with government monopolies, in one way or the other, they are also competing with each other to create a niche for themselves. Anand opines, "Presently most of the companies are busy setting up their offices and establishing agent network and the market is yet to witness a full-fledged competitive environment." However, the entry of big private players and multinational insurance companies has created ripples in both LIC and GIC. Both of them have been forced to act immediately to sustain their market initially and then to expand to survive.

To compete and survive in this highly competitive environment, insurers are choosing different strategies. "In the insurance sector distribution strength is the key to success. And the new insurers are finding new ways to reach their prospects. The Insurance Amendment Bill assumes importance at this stage as, among others, it will also allow co-operatives, Banks (bancassurance) and brokers to operate in the insurance sector," says Anand. All the players are trying to build their distribution channels. For example, insurers tied up with banks (SBI Life and ING Vysya Life Insurance) are using the bancassurance to reach the customers. Those in mutual funds and other financial services (Om Kotak Mahindra Life Insurance, Bajaj Allianz General Insurance, Royal Sundaram General Insurance Company and TATA AIG General Insurance) are trying to use their customer databases to tap the customers. Some insurers like ICICI Prudential Life and HDFC Standard Life are trying to reach prospective customers through the development of field network on the lines of LIC. These strategies are aimed at leveraging the existing customer databases to cross-sell the products. Supporting this view, says Anand, "To give an example IFFCO-Tokio Sankat Haran policy comes into force whenever a farmer buys 50 kg of fertilizer from KRIBCO or IFFCO. This policy is likely to find a place in the Guinness Book for being the largest single policy being serviced in the world. Similar paths are being treaded by the likes of ICICI Pru, HDFC Standard Life and Bajaj Allianz." Bajaj Allianz General Insurance, for instance, has been very aggressive in marketing its products. It has established tie-ups with retail giants like Shoppers' Stop to market its products along with its dealer network. The recently announced MUL foray into insurance is also a tie-up with Bajaj Auto Finance Limited (BAFL). At the launch of its operations, it has also used the customer database generated by BAFL and had offered the customers of BAFL free motor vehicle insurance for one year. ICICI Prudential Life and HDFC Standard Life are also thinking about linking their products with insurance to gain a foothold in the market.

The various players are also adopting different strategies on the service front by setting up national level call centers, interactive voice response systems and websites that provide interactive tools

"Rural insurance should be looked upon as an opportunity and not an obligation. It is important to take advantage of the immense potential that resides in the rural sector."

*B Anand, CEO,
Bimaonline.com*

and are helping customers to plan their needs, to beat the competition. "Some companies have adopted the principle of customization and flexibility to market their products. They are banking on the fact that each individual's needs are different and insurance solutions have to be customized to match those needs," adds Anand. This strategy is helpful for the insurers to create a niche for themselves. This is particularly true in the life insurance segment where the needs and priorities of the customers determine the policy terms and conditions.

The competition in the sector is so intense that it has become difficult to identify the crucial success factors. While some argue that product innovation is going to be the crucial factor in the success of the insurance company, others argue that service and quality of distribution will determine the success. However, Anand feels, "Insurance companies will need to expand the markets rather than vying for the same customer base. Critical success factors would be fund management capability, distribution and good underwriting practices." All the new players supported by their global partners are believed to be good in product innovation and providing quality services. Besides, technology plays an important role in providing competitive edge—designing and administering products and services and building long-term customer relationship. Anand further adds, "Technology will help enhance service, ensure effective and efficient service delivery and lead to greater customization of products and greater transparency." Moreover, all the new entrants are promising to speed up the process right from bond issuance to claims settlement. This is a very good thing considering the poor state of

services being offered by the state-owned enterprises.

While the competition has sent strong signals to the state-owned enterprises, LIC still seems to control the market. The insurers in non-life segment are finding it difficult to compete with the new private players and have lost a considerable market share to the new entrants. On the other hand, customers are going to benefit immensely from the competition in the industry. Customers have become the main focus of the business. As far as the state enterprises are concerned they have to realize the importance of customer and change their mindset to become more customer focused.

"It is already a buyers market now. He can benefit by new customized products to match his needs, better service and of course he will be able to get the value for the money spent, both in terms of insurance coverage and returns. The most important change would be that his claims will be settled faster," opines Anand. In fact, it is true that competition has brought cheers for the customers. Today the customers are offered products to meet his individual needs rather than mass customized products. For instance, a customer who had opted to go for life coverage had limited choice with only one player offering the services. But now with more players in the market his choice is unlimited. Similar is the case with non-life insurance segment.

Adopting divergent marketing strategies and using alternative distribution channels, all the players are confident about creating a big market in India

Is there enough room?

No doubt, the competition will be immense in the years to come. But how many players can the industry accommodate? Will the competition lead again to the pre-nationalization situation? These are only a few questions. Considering the future growth potential of the industry, the total market is going to be around Rs 200,000 crore. If this is split into life and non-life, finding a solution to the questions becomes easier.

In the life segment, it is expected that LIC will be able to retain a market share somewhere between 70 percent to 80 percent. Though LIC at present has a market share of 95 percent, owing to competition this is bound to come down in the next six years. This leaves the new entrants with a market of around 20

percent to 30 percent. The main concern raised by many people before the opening up of the sector was based on this residual market share. Is this large enough for the new players to reach scale and become profitable? As quoted by several international players, the minimum acceptable rate of return on investment in life market is around 25 percent on an operating basis. To enter into insurance in India the capital investment required ranges from Rs. 250 crore to Rs. 350 crore as laid down by the Insurance Regulatory Development Authority (IRDA). In terms of profit terms, life insurers can expect net margins between four to eight percent. To achieve a minimum 25 percent operating return on investment of Rs. 350 crore, the insurer must earn an average profit of around Rs. 80 crore. This implies that the required revenue should be approximately around Rs. 1200 crore. Considering the residual market of Rs. 30,000 crore to Rs. 40,000 crore (as per CII estimates), and minimum revenue of around Rs 1200 crore for each player, the market has the potential to accommodate around 20-30 players.

As of date there are 12 players in the segment and a few more in the pipeline. At present, it looks like IRDA's caution in licensing the entrants will translate into a great market opportunity for the new entrants. Considering the number of licenses to be issued in the next five years, achieving the minimum scale of profitability appears to be realistic.

With respect to the non-life segment of insurance, the picture seems to be slightly different. Since the size of the market is smaller than that of the life, the figures are going to change. It is expected that GIC will be able to retain around 50 to 60 percent of market share by 2008. This leaves the new entrants with a market of about Rs. 20,000 crore to Rs. 25,000 crore. The minimum acceptable return in case of non-life business as quoted by international insurers is about 20 percent. To enter into non-life insurance segment in India the minimum capital investment is around Rs. 175 crore to Rs. 250 crore. To achieve the minimum return on investment, new entrants must earn average profits between Rs. 35 crore to Rs. 50 crore. Taking average profits margins of three to six percent, this

translates into required revenues of approximately Rs. 900 crore. Given the market size of the segment, the expected number of players that can be accommodated in this segment will be around 18-25. Given the number of licenses to be issued here, the new entrants have ample chance to create a niche for themselves and compete head-on with GIC in the long run.

Future outlook

Any doubts about revisiting the pre-nationalization situation are cleared by the cautious approach of deregulation adopted by IRDA. The gradual development of competition in both life and general insurance business should be translating into benefits for both new entrants and consumers and the industry as a whole. Though the industry has not yet witnessed the real competition, big players are already feeling the pinch. Adopting divergent marketing strategies and using alternative distribution channels, all the players are confident about creating a big market in India.

Commenting on the future of insurance industry, Anand opines "Taking a long-term view, a day could come when some of the insurance products would attain a commodity status and you may be able to buy insurance through a mall or a grocery store. Such changes have been seen in developed countries such as UK where pure term products are sold through the retail chain outlets." He further adds, "New developments that are likely to be seen in the insurance sector are online payment of premiums through payment gateways and online sale of policies."

However, there are certain areas where improvements have to be made. Says Anand, "Indian insurance sector has a long way to go. Insurers need to build adequate historical data on which they can base their decisions like pricing. Important products like health insurance are yet to take off as the infrastructure like third party administrators and Health Maintenance Organization (HMO) are not yet in place." Since the time spent by the new entrants is less than two years, one can be sure that they will be attending to these vital issues once they commence their operations fully. In all, the changes being introduced in the insurance sector is forcing the industry to undergo a healthy paradigm shift. ■

Y Chandra Sekhar, Team Analyst

Reference # 1-2002-06-05

FINANCIAL MARKETS

Hedge Funds

Having the edge?

Hedge funds are proliferating, spurred by claims of better performance and higher returns in a presently dull stock market. They have attracted investors' attention especially with institutional investors increasing their allocation to funds but issues of transparency, disclosure and regulation are yet to be resolved.

The hedge fund industry is back in the limelight and this time for all the right reasons. The relative superior performance of hedge funds, at a time when markets are down and are mourning the fall of technology stocks, is what that is grabbing everyone's attention. The hedge fund industry has grown at an average 25.74 percent a year, showing a staggering growth of 648 percent in the last decade. The number of hedge funds operating the world over is around 6000 and the amount of investments is estimated to be worth \$400 to \$450 bn up from a mere \$15 bn in 1990. Besides this, \$50 bn is estimated to be in privately managed accounts within hedge funds and \$100 bn more under management with other hedge funds that refuse to report to information service providers. The Trading Adviser Section System (TASS) Asset Flows Report on the industry, compiled by TASS Research (a business unit of Tremont Advisers Inc.) and has a database of over 2000 funds and managers shows that \$8.8 bn in new money poured into the funds in the fourth quarter of 2001; this alone exceeded the total flows of the previous year, which amounted to \$8 bn. The reason is obvious—the average hedge fund has outperformed the market. Of course that is what hedge funds supposedly do—they generate returns independent of the movements in the market.

In a bear market, hedge funds are expected to perform better than the others and the figures prove this. While the Standard & Poor's 500 stock index dropped 13 percent in 2001 and the Dow Jones industrial average fell seven percent, the average hedge fund earned a 3.2 percent return. Historically hedge

funds have shown low correlation with the market and lesser volatility with higher returns. According to Van Hedge Fund Advisors International, Inc., Nashville, USA, between 1988 and December 2000, the average US Equity Mutual Fund lost 43.8 percent and the S&P 500 lost 41.2 percent but the average US hedge fund gained 0.2 percent.

DK Malhotra, Associate Professor of Finance at Philadelphia University, feels "The recent growth is due to the meltdown in the tech sector and the lackluster performance of both the stock market and mutual funds. Investors looking for good returns are turning to hedge funds and therefore the trend is just a market-driven phenomenon." He also opines "if the stock market rebounds hedge funds will have to compete with other funds for investors' money and hence their growth will slowdown." David R. Friedland, President of Magnum

Historically hedge funds have shown low correlation with the market and lesser volatility with higher returns

US Investments, Inc., echoes the same opinion. He observes that the pace of growth is unlikely to continue but the industry will certainly continue to grow. According to him a large influx of assets from retail investors is coming into hedge funds but this influx might lower return expectations for the entire industry, because too much money will be chasing too few investment ideas. Eventually as the returns fall, investors will reduce their allocations of money to hedge funds. Thus popularity is a cyclical phenomenon with money flowing in when returns are higher and flowing out the moment they cannot be sustained. Dr. Philipp Cottier, Chairman of the Board of Directors and CIO of Harcourt Investment Consulting AG, however, predicts a very optimistic future for the hedge fund industry. "We forecast a



Compound Annual Growth Rate (CAGR) of 25 percent for private banks and High Net Worth Individuals (HNWIs) and 40 percent for institutional investors over the next five years. Reasons. Hedge funds are simply a better asset management model allowing more efficient capital allocation, and they certainly have a better risk/reward than other investments."

Nilesh Shah, CIO, Templeton AMC, Mumbai, is skeptical of the high returns shown by the funds because it is easy to show high returns for a small hedge fund but very difficult to generate the same high returns on a large fund.

History of hedge funds

Looking back, hedge funds are usually popular for a short-term period. History shows that they catapult into the financial center stage suddenly and then disappear. They originated in 1949 when AW Jones, a reporter with *Fortune* magazine started the Jones Fund. Hedge funds proliferated in 1968 (after an article in *Fortune* in 1966 by Carol Loomis highlighted the spectacular performance of Jones' fund) and numbered around 140, only many fell gracelessly in the bear markets in the 1970s. In the 1980s, the number of funds reduced to 100.

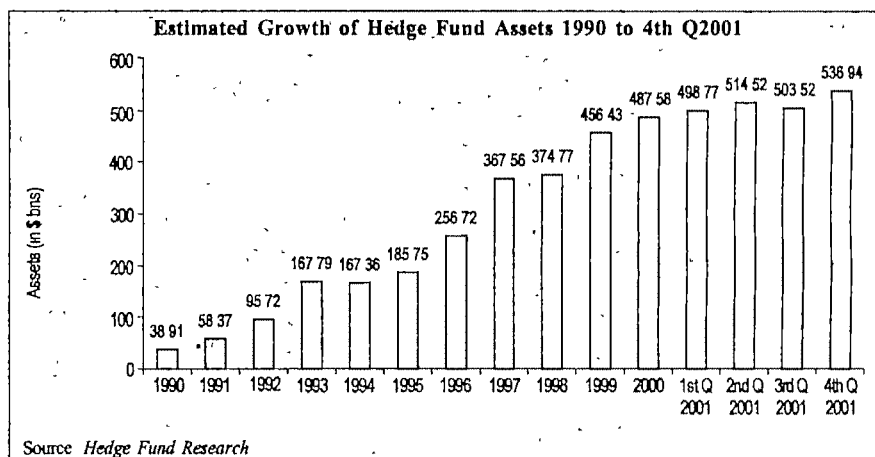
For sometime no one heard or tried to hear of them until George Soros and Julian Robertson resurrected them in the 1990s. The lost glory seemed to be restored with their funds, Quantum Fund and Tiger Funds respectively, outperforming the markets. In 1976, Quantum Fund registered a growth of 61.9 percent while the Dow increased by 23 percent.

LTCM: Ringing the alarm bell

Though Quantum Fund and Tiger Funds attracted the media, it was LTCM, however, that sketched vividly the spectacular rise, the inherent risks and dangers of hedge funds while ironically writing its own ruin. Managed by an impeccable and winning team of John Meriwether, and Nobel Laureates Robert Merton and Myron Scholes, LTCM catapulted to fame by reporting spectacular returns. But its high leverage policy boomeranged (the leverage was a factor of 40); its bad debts amounted to \$1 tn while it had only \$2 bn in assets. According to some estimates the gross value of its contracts exceeded \$1 tn. But what spelled doom was the intricate web in which financial institutions and banks, spread over myriad products—derivatives, stocks, commodities—across the world's financial market were entangled. The implications were so great and so feared that the Federal Reserve Bank of New York arranged to bailout LTCM privately with a consortium of 14 major international financial institutions together contributing \$3.6 bn.

It was LTCM that alarmed markets, investors, regulators, bankers and others and alerted them to the risks and dangers of hedge funds. Consequent investigations by authorities and research have however proved that, thankfully, LTCM was only a unique exception and does not reflect the typical hedge fund. Indeed no one fund can completely or entirely depict the nature of hedge funds. Such is the diversity of hedge funds. These funds are typically privately organized, usually in limited partnerships or as offshore investment corporations to avoid regulation by the Securities Exchange Commission (SEC), which means that they are free to choose from a vast basket of investment opportunities, to engage in short selling, to operate in wide range of markets, are not bound to disclose their operations, and extensively use leverage and derivatives.

But this freedom of operation comes with constraints; hedge funds are open to "accredited investors" who have a \$1 mn of net worth or \$200,000 of annual income



for each of the past two years and expected in the current year (or \$300,000 for a couple) and the number of investors is limited to 99 but the fund manager can accept 34 unaccredited investors among these 99. Another variation of hedge funds is one where the number of investors is limited to 499, but every investor must have \$5 mn of investible assets. These rich investors are expected to fend for themselves as they have the resources and financial muscle to extract useful information and face risks. However, Friedland feels that the industry is opening up to retail investors too with minimum amounts being brought down and closed-end funds introduced. Malhotra, however, believes that the hedge funds, given the high investment amounts, are not popular with individual investors and the industry is still in an infancy stage. Once the industry moves to the next stage through consolidations and mergers, hedge funds may become popular with the small investor.

An important restriction is that hedge funds do not allow daily redemptions; typically redemptions are quarterly and require notice in advance; it is common for funds to lock in the funds invested for three or five years. They are also prohibited from advertising and place funds privately through placement memos. In addition to the management fee, which is generally one percent, hedge fund managers earn a percentage of profits (a feature which distinguishes them from mutual funds), generally around 20 percent. Hedge fund managers invest their own capital into the fund, which is an inducement to them to manage the fund better and for the investors to place their trust in them. The common strategies are macro, market neutral, emerging markets, distressed

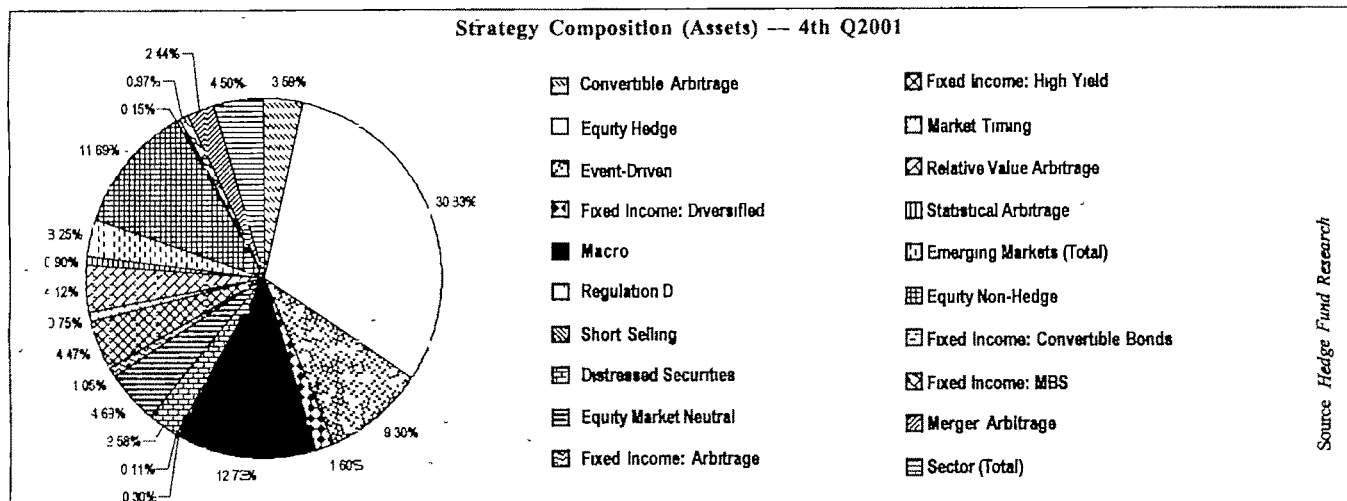
securities, convertible arbitrage, etc. All these strategies are, however, not entirely exclusive to hedge funds and others including mutual funds and financial institutions use them. Hence the distinction between hedge funds and other funds becomes nebulous.

Present trends

The confidence of investors in hedge funds remains a little shaken even today, three years after LTCM. Recently, two hedge funds run by celebrity money managers collapsed in New York causing further worry to investors. Some fund managers have rushed to allay the fears of investors by writing to them, trying to describe their risk management practices. The industry is allegedly luring dubious characters including convicted drug dealers and money launderers. The Managed Fund Association has recently published extensive anti-laundering policies for hedge funds.

All these notwithstanding, the present bear market, which is the right environment for hedge funds to flourish, has led to increase in number of investors actively involved in hedge funds. Pension funds and endowments are interested too and many are outsourcing their funds to alternative funds. Some of the world's largest pension funds and life insurance companies like ABP, PGGM, Calpers, Sumitomo, and Nihon etc., have started investing large sums in hedge funds. Individuals own more than 80 percent of the hedge fund assets, with the balance held by a growing number of institutional investors. The pension-fund industry's share of hedge funds increased 76 percent a year from 1996 to 2001, according to financial-services consultants Casey, Quirk & Acito LLC in Darien, Connecticut. Some of the hedge funds are being turned into aggressive

HEDGE FUNDS



growth or arbitrage funds. Other funds are being turned into closed-end funds so that the funds are stabilized and fund managers need no longer hesitate to take hard decisions as the investors' money is locked in for fixed and known periods. Stable funds are expected to reduce the cyclical nature of hedge funds.

Another significant trend is the migration of mutual fund managers to the hedge fund industry. Mutual fund managers are being lured by the freedom, secrecy and profitability of the hedge funds which is radically different from managing mutual funds with the regulatory rules, public accountability and the need to show better performance than the market on a daily basis. No wonder more and more mutual fund managers are willing to make the career transition.

The Economist and Barton Biggs, Chairman, Morgan Stanley Investment Management Funds, have expressed fears that this growth may only be a bubble. The growth of funds has been along these lines. Half of hedge funds are run on the long/short strategy. According to the TASE Report, 42 percent of assets or \$110 bn recorded in the fourth quarter of 2001 were run on long/short strategy. Other popular funds in the fourth quarter of 2001 were event-driven followed by global macro funds. Offshore funds have grown rapidly in Bahamas, Cayman Islands, Luxembourg and Ireland. The European Union is also a fertile ground for hedge funds. However, the opportunities for making profits on arbitrage in the foreign exchange markets have diminished with the introduction of euro. Indeed foreign exchange markets were the hunting grounds for hedge funds during the peak

of LTCM. Hedge funds have benefitted from the anomalies and inefficiencies in the emerging markets. In fact they came under attack for destabilizing currencies of emerging markets during the Asian crisis in 1997. The Malaysian Premier, Mahathir Mohammad, criticized hedge funds for carrying out manipulative and speculative practices.

Providing the much needed speculation and liquidity are the benefits proffered by hedge funds. But markets suffer from herd behavior, which means that others imitate the hedge funds' actions and moves multiplying the effects and the risks. This translates into great power for hedge funds in the relatively smaller emerging markets. No wonder the Asian crisis triggered debate on the role of hedge funds and brought the issue of regulation to the forefront.

Regulatory concerns

Regulation, or rather the lack of it, is a key aspect of hedge funds. Hedge funds are subject to general rules against fraud. Investors can demand information about the strategies, leverage parameters, positions etc., from their fund managers. A majority of hedge funds, which are active participants in futures markets, fall under the regulatory framework of the Commodities Futures Trading Commission and, therefore, comply with the rules on reporting. They are also subject to the record keeping and reporting requirements of the Department of Treasury. Comprehensive information about the hedge funds' activities, positions and risks is, however, unavailable. But government bodies and the SEC cannot demand and do not receive information from hedge funds about their operations. It is this non-

disclosure of information that poses threat of unethical and illegal practices.

This means that trading partners and lenders do not have adequate information to assess the risk profile of hedge funds. Free movement of funds from one country to another, and through the derivatives, foreign exchange, futures markets etc., manifests itself as a great risk which is hard to measure. Leverage is resorted to extensively to generate higher returns and this creates high levels of risk. This problem was well illustrated in the LTCM case. Regulation of highly leveraged institutions was recommended by the Financial Stability Forum set up in UK in the wake of LTCM's collapse. The Baker's Bill proposed that funds should make reports to the Federal Reserve and the Fed should make available part of this information to the public. Analysts and others, however, point out that it is the financial institutions and not hedge funds that should take the blame for magnifying risks.

Financial institutions have been lax in evaluating the risk of highly leveraged entities like hedge funds and have been unable to appraise their risk exposure accurately. Basle Committee emphasized the view that banks have the principal responsibility of managing their exposure to highly leveraged institutions and other counter parties. The argument that ensuring risk management and prudential requirements by counter parties like lenders is more appropriate than direct regulation of hedge funds is, therefore, valid. Actually, supervision and regulation of hedge funds is argued to be unnecessary since the wealthy individuals who invest in them are capable of taking risks. According to Malhotra, to the extent that certain

activities of highly leveraged institutions can pose particular risks, not only to direct counter parties but, under certain market conditions to the financial system as a whole, supervisors should ensure that the proper incentives, procedures and standards are in place to encourage prudent management of these exposures by banking institutions.

But even if regulations are in place it becomes extremely difficult to monitor whether they are followed. The international nature of hedge funds raises questions about legal jurisdiction. How can offshore funds be regulated? Domestic regulations might force funds to move offshore making their monitoring and regulation even more difficult. Moreover, the dynamics of hedge fund operations is such that positions and the amounts involved change rapidly. Dr. Vikas Agarwal, Assistant Professor of Finance, Georgia State University, observes "In terms of the risk management techniques, it is not clear that standard methods such as Value-at-Risk can be applied in the conventional way to hedge funds and can effectively reflect the riskiness of their strategies." It is difficult to identify, analyze and measure the risk profile of funds because of the interplay of different products, markets and exposures across global markets. This implies that no single regulator can really know or comprehend the risk and exposure of a hedge fund. Unless regulators of different countries come together to create a mechanism where information can be shared or collected, the threat to financial market stability (assuming that such threat from hedge funds does exist) cannot be minimized. The threat now from hedge funds per se is remote because they occupy a tiny portion of the global markets; they account for only 1.0 percent of global markets, 0.6 percent of global stock and bond markets and 3.0 percent of global mutual funds and cannot destabilize markets on their own unless something is seriously wrong with the markets.

Performance evaluation

The lack of information has not only created problems for regulation but also made monitoring of the performance of the industry difficult. Hedge funds are not obliged to disclose their results. The number of funds and the amount involved is not available and statistics for the overall industry are compiled from the voluntary information provided by

some funds and based on estimates of others. Dr. Cottier finds the HFR (equal weighted) and the CSFB Tremont (asset-weighted) indices to be the most reliable. He, however, estimates that they contain a survivorship bias of around 1.5 percent and feels that the individual sub-indices for each strategy are more interesting to watch than the composite indices.

Even when information is available it is hard to reconcile data into a uniform format and measure performance because the hedge funds industry is divided into a number of segments with each fund following a different strategy and having a different redemption date. Hence it is extremely difficult to create an index, which can be used to measure the risk and return of a hedge fund. Nilesb Shah opines, "At the end of the day if the hedge fund industry has to attract money from people at large they have no option but to sell their performance on a relative basis i.e., vis-à-vis an index which their clients can easily understand." Comparison of hedge fund performance with that of S&P 500 has been the basis for claiming superior performance of hedge funds. However, considering that some of these hedge funds have low or no exposure to the S&P 500 index, it is unclear if S&P 500 can serve as an appropriate benchmark for adjusting systematic risks.

According to Friedland, the indices are not efficient in portraying a fair picture of hedge fund operations because the indices rely on voluntary information, exclude funds that are closed to new money or that are not being actively marketed and do not account for funds that blew up as figures are not reported for the period when funds suffer losses. The demand for transparency and disclosure of information is rising. This will not only assist in better performance monitoring but also help regulators, banks and investors in making informed decisions and boost investors' confidence. Transparency will draw investors, strengthen market discipline and increase profitability of hedge funds. However, more disclosure of portfolio holdings and positions can benefit copycats who will know the positions and strategies of hedge funds and imitate them. This will have implications on the profitability of hedge funds.

Future outlook

The hedge fund industry is predicted to grow though not at the high pace as seen today. But the prospect of hedge funds

"At the end of the day if the hedge fund industry has to attract money from people at large they have no option but to sell their performance on a relative basis."

*Nilesb Shah, CIO,
Templeton AMC,
Mumbai*

making a gala entry into developing countries like India seems a little far away now. Of course, some Indian promoters are already operating hedge funds in their private investment companies. But their performance is questioned, as they are believed to resort to insider trading and dubious practices, cheating and duping investors. Liquidity, leverage, a developed market for derivatives and short selling along with good corporate disclosure are all needed for hedge funds to proliferate and all are missing in India. On the other hand, markets are still evolving and loopholes abound and this can prove fatal if an LTCM collapse were to occur. Malhotra warns that hedge funds should be allowed only after either establishing internal controls for the banking industry or having a watchdog in place. According to Nilesb Shah, the availability of leverage through official sources is difficult because of their apathy to risks and, therefore, hedge funds in India will remain within the domain of Indian promoters and not Indian investors. Persistent questions and concerns on the profitability, prudent management and regulation are still unanswered. The big question is whether the superior performance is a superficial, short-term gain over a depressing market or a real one, which can be sustained and improved. Those who dare will take the plunge and those who don't will have the benefit of hindsight. ■

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T Aparna, Team Analyst

Reference # 1-2002-06-06

INTERNATIONAL FINANCE

Argentina

The shadows lengthen

With Argentina teetering on the verge of a collapse, the only way out of the mess is to bring in swift macroeconomic reforms together with active participation of the common Argentine. Any further delay, the country will go past the point of no return.

A few months ago, Argentina was merely suffering from a common cold. And then pneumonia set in, followed by a severe attack of Ebola and with this, the country is now virtually on its death bed. If the country is to survive, all the bad blood needs to be drained and fresh blood pumped in, fast. But the moot question is: How?

A lot of water has flown under the bridge since the last time we took a look at Argentina's flailing economy (See article: 'Dark Shadows', *Analysis*, February 2002). In the aftermath of the collapse of the country's fixed exchange rate, the Argentine President Eduardo Duhalde had devalued the peso and set a new exchange rate on January 6, 2002, at 1.4 pesos to the dollar as against the previous rate of 1-to-1.

'Floating' into the unknown

When it became clear that the fixed exchange rate was no longer helping the economy, the Economy Minister Jorge Rives Lencov unveiled a new plan on February 3, 2002 that floated the peso, with the hope that the move would stop the country's economic and political implosion. The plan also forced banks to convert all their dollar loans into pesos at the old rate of one-to-one while dollar deposits were converted at 1.4 pesos per dollar and then indexed to inflation.

The floating peso came into being on February 11, 2002, when the foreign exchange market opened after a "holiday" of one week, and the currency immediately slumped to about 2.03 pesos per dollar on the very first day. Although the Government initially tried to prop up the currency, lack of reserves forced it to give up the plan. The currency is trading

in the range of 3.15-3.25 pesos against the dollar (at the time of writing this article) a loss of more than 70 percent since the dollar peg was broken, while reaching as low as 3.9 pesos per dollar on March 25.

With growing pressures on the already wobbly peso and no sign of an agreement with the IMF, the Government imposed further restrictions on the foreign exchange market on March 25, 2002. As per the new regulations, individuals can purchase no more than \$1,000 in dollars each day while registered companies are limited to \$10,000 in US currency a day. Currency exchanges may operate for only three and a half hours a day instead of the usual seven. The Government also put new limits on the amounts of dollars that banks and businesses can hold and restricted the ability of investors and brokerage houses to move money abroad through stock purchases in the US.

On April 23, 2002, the Economy Minister Lencov resigned after having failed to mop up the bailout package abroad and garner enough support from the Congress to approve a plan to turn savings deposits into bonds plunging the country into further economic and political turmoil. His replacement, Roberto Lavagna, former Argentine ambassador to the EU and the WTO, took

Argentina's Supreme Court made a unanimous ruling on February 1 that the banking freeze that had been in place since December was unconstitutional

charge of the toughest job in Latin America on April 27—guiding Argentina to some sort of economic stability. In his first major policy move, the new Economy Minister persuaded the President to allow the peso to continue to float and abandon the plan for another fixed exchange rate, at least for the moment.



Banks slip further downhill

In spite of the *corralito* or the freeze on bank deposits, which triggered bloody protests during Christmas in 2001 and eventually led to the fall of the then de la Rúa government, money continued to fly out of Argentina's banks. In a major blow to the reigning Government, Argentina's Supreme Court made a unanimous ruling on February 1 that the banking freeze that had been in place since December was unconstitutional. The court held that the freeze was "irrational" and it "annihilated" constitutional rights to private property.

Following the ruling that the freeze on deposits was unconstitutional, the then President came up with a new executive decree that suspended all judicial challenges of the freeze on bank deposits for a period of 180 days. However, judges defied his new decree and ordered the police to arrest bank managers who do not comply with their rulings. Today, nearly \$50-100 mn exit the banking system every day as thousands of depositors continue to win court rulings that free their money.

With two-thirds of bank deposits being denominated in dollars, the banks

suffered an immediate loss of 0.4 pesos when they were forced to convert their dollar deposits into pesos, which were to be compensated through the issuance of new government bonds of about \$20 bn. However, the value of the government debt can be taken only with a pinch of salt as the Government has already defaulted on its debts. With the scrapping of dual exchange rate system, the banks were also instructed to sell all their dollars, including reserves, to the Central Bank. All in all, the Argentine banking system is on the brink of a collapse.

Dr. Steve H Hanke, Professor of Applied Economics at The Johns Hopkins University, Baltimore, USA and Member of the Steering Committee of The G-7 Council in Washington, D.C., asserts, "The banks in Argentina are insolvent. The owners of the banks are reluctant to pump more capital into banks that the Government has repeatedly robbed. And the Government is in no position to recapitalize the system. Perhaps it's time to face the music, declare the banks bankrupt and liquidate them, with the depositors having first claims on the assets."

Professor Joseph T Salerno, senior fellow of Ludwig von Mises Institute, Alabama, USA and editor of the *Quarterly Journal of Austrian Economics* goes a step ahead. He feels that with the demand liabilities of each bank, including savings and checking accounts, written down to the level of its cash

reserves and then pro rated among its depositors based upon the size of their nominal deposits, the currency will immediately return to circulation. "Since they now will be effectively backed 100 percent by cash, depositors will then be able to freely redeem their deposits in currency or continue to access them by

cheque or debit card without threat of a contagion of bank collapses," says Salerno.

In addition to this, Salerno suggests that the ownership of the loan and investment assets of each bank be transferred to the depositors by distributing equity shares with the nominal shares received by each individual being equal to the original quantity of pesos in the bank deposit less his/her quota of the banking system's cash reserves. These shares should be saleable on the market with the price of the share being determined by the market value of the asset portfolio. "All banks will thus be split into two independent institutions, a 100-percent deposit bank and a no-load mixed-asset mutual fund. Argentine depositors of all income levels will now have unimpeded access both to a medium for making current exchanges and to their savings," says Salerno.

Budget cuts: An eye wash

After hectic parleys, the Duhalde government finally got its budget approved by the Congress on February 28—a budget that cut spending by 15 percent (or \$3.6 bn) as compared to last year and involves belt-tightening exercises from provincial governors. According to the budget projections, the Argentine economy is expected to contract by 4.9 percent with inflation hovering at about 15 percent and a

fiscal deficit of 3 bn pesos (as against 10 bn pesos in the previous year), which most of the analysts consider highly optimistic.

"The budget numbers don't add up. The proposed budget is largely nonsense," says Hanke. True enough, the Government has itself admitted in March that it ran up a fiscal deficit of 780 mn pesos (\$319 mn) in the first two months of 2002. If the present trend is to continue, which is very likely, the overall fiscal deficit will overshoot the budget target by a huge amount.

News on the inflation front is no better. Although the Government put the official inflation rate at five percent for the first two months of 2002, consumer groups complain that prices of basic foodstuffs have shot up by more than 40 percent during the recent weeks.

"The Government is in no position to recapitalize the system. Perhaps it's time to face the music, declare the banks bankrupt and liquidate them, with the depositors having first claims on the assets."

*Dr. Steve H Hanke,
Professor of Applied Economics
at The Johns Hopkins University,
Baltimore, USA*

According to Dr. Antony P Mueller, Professor of Economics at the University of Erlangen, Nuremberg, Germany and currently a visiting Professor for International Finance at the Universidade Federal de Santa Catarina, Brazil, "Budget cuts are a sideshow to the real problem of controlling inflation, which may drastically exceed the Government's projection. Individual measures will be of little avail in a country where the population has lost all confidence in money and politics. In the current situation, the insistence on budget cuts will do more harm than good." Argentina's citizens are suffering from a new kind of disorder. Dubbed *La Fiebre Verde* or Green fever by the media.¹

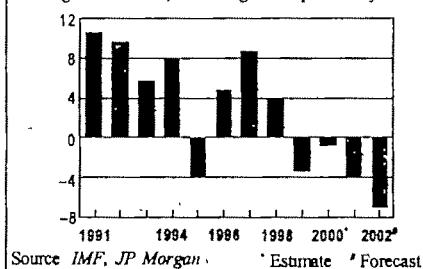
Things are really looking bleak for Argentina. Till March 2002, industrial output fell by 15 percent as compared to that in the corresponding period in 2001. There are wide-spread fears of shortage of home-made goods as well as imports. By the end of April, unemployment stood at nearly 23 percent and 57 percent of Argentines were officially classified as poor. One out of every five citizens does not have income even to meet basic nutritional needs. Above all, every one of them suffers from an entirely unknown ailment—Green fever.

The Green fever

Clutching their money belts, darting their eyes on the look out for thieves and constantly whipping out their pocket calculators to calculate the fast changing exchange rates, Argentina's citizens are suffering from a new kind of disorder. Dubbed *La Fiebre Verde* or Green fever by the media, it leads to desperation and mistrust of the peso. The only known cure: A fistful of US dollars.

Argentina's citizens are suffering from a new kind of disorder. Dubbed *La Fiebre Verde* or Green fever by the media.

How Argentina Fared in 1990s
Argentina's GDP, % change over previous year



ARGENTINA

The near hysteric desire for dollars highlights the psychological aspect of the country's current economic crisis which has made it very difficult for economists to find a way out for what was once Latin America's wealthiest economy. The common man in Argentina has lost confidence in the politicians, policymakers and even the society itself leading to a loss of confidence in the national currency. The dollar has become the nation's obsession.

The frenzy for the greenbacks has revived the notion among the financial circles that the only thing that can cure Argentina is to adopt the dollar as the local currency, a de facto dollarization. Although opinion polls show that the support for dollarization is growing, a majority of the Argentines, however, are opposed to the idea. So is the Government.

Dollarization: Will it help?

Many wealthy Argentines do much of their shopping in dollars. Even after the devaluation, some stores in Buenos Aires, including art galleries and antique shops, still quote their prices in dollars. Then why not dollarize?

Says Dr. Mueller, "Dollarization—like the currency board before—is one of the tricks that may work in the short run with unbearably high costs coming later on. Dollarization would just be another step in the Argentina's long history of financial illusions." According to him, what the country needs is not financial wizardry, but the reconstruction of solid foundations of its economy as well as the establishment of trust.

"These things require dedication and perseverance—and it must be done by the Argentines themselves. For too long a time, the illusion has prevailed that 'rescue' packages from the IMF could produce wealth or stability, or that 'confidence' could be imported by adopting the dollar without reforming the deeply corrupt political system and the extensive welfare state," he says.

Echoing the same thoughts, Salerno states that, "Dollarization is a gimmick that differs only formally from the currency board regime that resulted in Argentina's current fiscal and monetary crises. Moreover, it does not address the immediate problem of giving Argentines

immediate and full access to their money holdings and savings currently frozen in the banking system."

However, Dr. Hanke disagrees. According to him, dollarization would provide the much needed confidence shock as it did in Ecuador. "If Argentina hopes to re-emerge from its current chaos, its fiscal regime must be fully subordinated to its monetary regime. The only way to do this is to dismantle the Central Bank, liquidate the peso, completely dollarize the economy and prohibit the issuance of quasi-monies," he says.

However, dollarizing the economy alone will not solve all of Argentina's problems. Adds Dr. Hanke, "Dollarization is a necessary, but not sufficient, condition that must be satisfied before Argentina can reach its potential. The rule of law must be respected. No country can prosper if it fails to recognize the sanctity of contracts which are the foundation of all private morality and the indispensable condition of every sane social order."

Considering that the peso-dollar peg was effectively a form of dollarization, which did not help the country in anyway due to the inconsistencies in the fiscal and monetary stance of the previous

governments, it seems highly unlikely that dollarization would give a boost to the economy. Moreover, the country no longer has the support of the United States, which is very essential if it wants to dollarize.

What next?

Argentina is in no position to wait for any further funding from IMF, which is likely to take at least

another couple of months. In the precarious state that it is in today, it must act fast. The Government must realize that reform must come from within the country—a genuine change for the better needs the full-fledged support of all its citizens, without which nothing can be done.

"The Argentine Government should make it clear that it has no quick fix to offer, and that it is up to the people themselves to repair the system. The Government should concentrate on basic government functions and refrain from direct interventions, which have brought down the system in the first place," says Dr. Mueller.

"Dollarization—like the currency board before—is one of the tricks that may work in the short run with unbearably high costs coming later on. Dollarization would just be another step in the Argentina's long history of financial illusions."

Dr. Antony P Mueller, Professor of Economics at the University of Erlangen, Nuremberg, Germany

Argentina has been like a spoilt brat, who keeps coming to the father (read IMF) for rescue in times of distress. With the disgruntled father acceding to his requests time and again, Argentina had become bolder and bolder each time. Just as any father would have done, the IMF finally decided to put an end to the rescue tactics after a loss of face in the financial circles.

The Government has to take swift moves to declare the insolvency of the country's national and provincial governments, repudiate the country's public sector debt, cut spending and taxes while stimulating the domestic savings and investment in the private sector. The Government should make it very clear that it does not have any quick fix solution to offer and it is up to the people to repair the system.

It is also time for the common man in Argentina to come to a consensus as to what needs to be done. Knowing fully well that dollarization can only serve as a temporary measure, and without the necessary fiscal and monetary reforms even dollarization cannot help the economy in the short run, the people should tighten their belts and come up with a new economic plan sans dollarization to steer the country out of this terrible mess. As Dr. Mueller puts it, "Basically the country is very rich and the chance in the current crisis could be that a new kind of political and economic system will emerge from the ashes, a system that does away with the century-old Argentine tradition of placing politics and politicians at the top and putting Government in the center of distribution system that squanders the country's riches under the name of welfare and justice." ■

E Kalyan Babu, Team Analyst

Reference # 1-2002-06-07

Gold Prices

Demystifying the trends

Movement of gold prices have always fascinated traders and observers alike. Research reveals that gold prices are highly correlated with various macroeconomic parameters including inflation and dollar prices. Can they also forecast the prices of gold over a period of time?

Since ages gold has been admired for its luster. The use of gold for jewelry purposes has been traced to the pre-historic era. Since then it has never lost its popularity. Later people discovered its intrinsic value. People started using it as a medium of exchange and thus marked a milestone in the history of global monetary system. Gradually, the barter system, for its inherent transactionary problems was replaced by gold. Gold came to be accepted for its embedded material value as a better alternative and thus sowed the seeds of the present currency system. The citizens of the Kingdom of Lydia (western Turkey) claim to be the first users of gold as a currency in 700 BC. In the more recent history, the US Congress adopted a bi-metallic standard (gold and silver) for the new nation's currency in 1792, which was held until 100 years. Gold has become an important metal for investment and hence there is a lot of fluctuation in the prices of gold ever since.

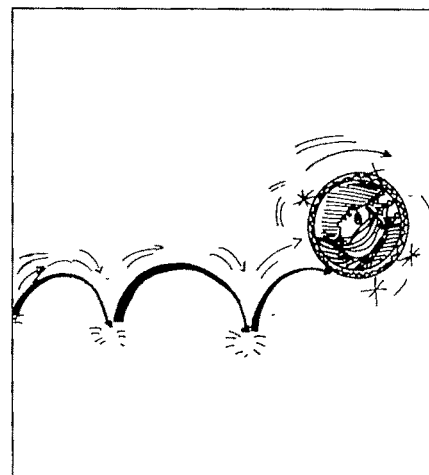
In the last 20 years after 1980 when the gold price was at its peak, gold has been giving a meager return of five percent. However, in the last one year it has given a 20 percent return with price coming up from \$255 to \$305 per ounce in the international markets. The recent increases in the gold prices can be attributed to various reasons like the worldwide stock markets crash after the dotcom burst; terrorist attacks on WTC, the Japanese banking system in doldrums, and the overall world recession. All of these factors contribute towards shifting the capital from stock market, banking system and other investments towards gold. There has been a gradual decline in the gold production in the last three years, which has again contributed to the increase in price. Although the recent

escalations in gold prices are due to these economic forces, these are short-term and what will be the gold prices in future and what will be the cyclical trend in the next few years in the absence of these short-term economic forces is to be analyzed. Paul Van Eden, who is a widely respected financial analyst and has written extensively about the relationship of the US dollar and the price of gold, observes that, "Less than 12 months ago gold was a dirty four-letter word and now it is being talked about in mainstream media."

Gold, dollar and inflation

To analyze the reasons behind the escalations in gold prices, the relationship of gold with dollar, inflation and deflation, among others, is worth discussing. A lot of research has already been conducted on fluctuations in gold prices, their correlation with the dollar, exchange rates, etc. However, if closely looked at the prices in the last few decades, a cyclical trend in the prices (even after lot of economic upheavals at various points of time) can be observed. As Steven A Saville, Editor of *The Speculative Investor* opines, "Gold mainly serves as a form of money, therefore it should be analyzed as money, that is, in the same way that we analyze the US dollar. One of the implications of this is that our focus should be on investment demand, not

fabrication demand, when analyzing the gold market." When looked from the demand-supply point of view, dollars are available in abundance contrary to gold, the supply of which is limited. Hence, over a long period of time the value of dollar tends to depreciate while that of gold tends to appreciate. However there exists a similarity between the behavior of dollar and gold prices in the sense that



the value of both is determined by the total supply and the investment demands.

The demand for gold increases, whenever there is a reduction in its prices. The demand reaches the peak when the prices hit rock bottom. Again it steadily declines over a period of time with the price remaining more-or-less stable. This phenomenon has been witnessed whenever there has been a significant fluctuation in gold prices. However, the price movements are such that, automatic market forces are created to maintain its stability.

Inflation is another parameter that has a significant correlation with gold price movements. The price of gold tends to increase as demand increases because there is a loss of confidence in the currency, which manifests in the form of inflation. However due to the strong intrinsic value of gold, it generally performs well in the period of deflation as the purchasing power for the same amount of gold increases and gold tends to be more valuable. This is evident by the fact that gold performed well during the deflation of 1930 and also at the time of South-East Asian crisis when the prices of gold skyrocketed due to the loss of confidence in the currency. As rightly

The demand for gold increases, whenever there is a reduction in its prices. The demand reaches the peak when the prices hit rock bottom

GOLD PRICES

pointed out by John Hathaway, MD of Tocqueville Asset Management LP, New York and the Portfolio Manager of Tocqueville Gold Fund, "Gold does well during periods of inflation or deflation. The common denominator is that the expected return on financial assets is low compared to previous historical periods. At the current time, the world is facing a deflationary threat caused by the over extension of credit during the 1980s and 1990s."

The value of dollar has declined over a long period of time. The factors responsible for the declining value of dollar can be various. The world economic events especially those related to US affects the dollar value. This has an important role in determining the value of gold as they result in an increase or decrease of confidence in the currency such as dollar. In the rise of gold prices after the WTC attacks, one of the factors could be the loss of confidence in the currency and shifting towards gold thereby increasing the demand of gold and hence the prices. However, Paul Van Eden says, "My view is that gold is money. Above ground gold, i.e., gold in circulation is analogous to money in circulation. Mine production is the gold equivalent of inflation. The reason why gold retains its value as money (or a store of wealth) is because over the long-term, one will find that the world's population growth is roughly one to two percent per year, which results in an economic growth of about one to two percent per year. Mine production as a percentage of above ground gold (money supply) is also about one to two percent per year. So the increase in the gold supply is in line with the increase in economic growth hence a stable gold price over time." Secondly, gold's supply is limited when compared to dollar; hence over a long-term the value of dollar depreciates.

Another factor for the declining value of dollar is inflation. However, inflation itself is the outcome of demand and supply; but if the purchasing power parity and the world exchange rates and not only dollars are considered, it can be seen that the prices of gold in dollar terms are lower than the world average gold prices in the last five years and in the same period the dollar exchange rates have

gone up more than the dollar gold price as well as the world average gold price. This indicates that gold is attracting more capital now when compared to dollars. Comments Saville, "The US dollar's trend is the most important factor determining the investment demand for, and therefore the price of, gold."

The gold exchange standard

The history of gold as an exchange standard will throw more light as to how gold prices react to various economic forces individually, ceteris paribus. Saville says, "Gold has never really lost its acceptance, but over the past 20 years the main focus of investment has been on financial assets (stocks and bonds). That cycle has ended and the focus of investment has once again begun to shift back towards hard assets including gold." However, due to an increased supply of gold from 1800-1900, there was abundance of gold in the world, which enabled gold to become the sole standard of value. After the First World War it was a desire of many nations to return to the gold standard at the parities of pre-war period. However, the fear that the system will fail led to 12 Currency Resolutions in 1922, many of which recommended gold exchange standard as a method to economize on gold. As a matter of fact, the gold exchange standard has collapsed twice, once in 1931 and then in 1971. Also, there were a lot of problems with the Bretton Woods agreement in 1960s.

The dollar became increasingly inconvertible, and by the late 1960s the system assumed the name, "dollar exchange" as it was in the 1920s. However, various studies indicate that despite all its evident failings, inter-war gold standard appeared to represent a highly credible fixed exchange rate regime. Commenting on the fiat currency system, Saville says that, "The fiat currency system relies on the supply of currency being expanded at a fast enough rate to enable past debts to be repaid, but this inherent instability is also why the fiat currency system will eventually collapse. We might already be in the initial stage of a flight from the dollar. This is a trend expected to accelerate over the coming decade, but there is no way of knowing how much time will transpire before there is

"Gold does well during periods of inflation or deflation. The common denominator is that the expected return on financial assets is low compared to previous historical periods."

*John Hathaway,
MD, Tocqueville
Asset Management LP, New York
and Portfolio Manager,
Tocqueville Gold Fund*

widespread non-acceptance of the dollar. It will happen, but we don't know when."

On the future of the currency system in the coming decades and the changes we might come across, Eden comments that, "the world will gradually move towards a single, electronic currency. The problem with a single currency is who will have the power to create it? What is it worth? Both of these problems can be solved by having an electronic currency backed by physical gold. This would, however, require substantially higher gold prices. In fact such a high gold price that I don't even want to tell you what it is because you may think it is ridiculous. Some people may say that the concept of a gold-backed currency is ridiculous. I would answer that the concept of fiat currency is far more sinister and unrealistic than a return to a gold standard." With gold experiencing transformed uses from exchange standard to an important element of reserves and investments, the price has been varying largely over a long-term period. This aspect is also very well described in the book *The New World of Gold* by Timothy Green. These price variations when analyzed properly could depict a cycle on which gold has been performing.

The gold price fluctuation cycle

According to Hathaway, "At three junctures during the past century, the price of an ounce of gold equaled the Dow Jones industrial average. The last time this happened was in 1980 when they both traded at \$800. However, the same thing happened during the 1930s and again in the very early 1900s. Recently, however, the DJIA traded at approximately 30 times the gold price.

Gold's supply is limited when compared to dollar; hence over a long-term the value of dollar depreciates

The explanation for these swings is the credit super-cycle, which is to say, long periods of credit expansion or contraction that supercede the business cycle." When we analyze the fluctuations in the gold prices against dollar from 1968 till date, the gold price went up to \$850 in 1981 and crossed \$500 mark in 1987 and then steadily came down at the present level touching a low of \$250 in 1999 almost half of the price in 1987. Hence a trend of decreasing prices in the last 17 to 18 years ignoring the small cyclical fluctuations can be seen.

Saville summarizes the cycle, "There is a cyclical trend in the ratio of the stock market (as represented by the Dow Industrials) and the gold price. This ratio made long-term peaks in 1929, 1966 and 1999, and long-term bottoms in 1932-1933 and 1980." The reason for the decline in the US dollar gold price is the strength in the US dollar. As Hathaway says, "The dollar is worth a small fraction of its value 50 years ago. Even though gold prices declined steadily for the 20-year period from 1980 through 2000, and have risen only slightly since then, they are nearly 10 times what they were 50 years ago. The history of paper money is that it eventually loses most of its value. The apparent appreciation in gold is simply the flip side of falling paper currency values."

The average gold price is almost stable as unlike the dollar, it indicates that gold has not lost its value. The strength of dollar is based on the confidence in the US economy and the stock market. This can derive a relationship between dollar and gold that a decline in dollar exchange rate should lead to increase in demand for gold thereby increasing the dollar gold price, and a decrease in demand for gold should result an increase in demand for dollars thereby pushing the dollar exchange rate up. This also indicates that as and when any economic event occurs, which affects the US economy adversely, the impact should be an increase in the dollar gold price and vice versa. Eden, on the cyclical trend states, "The gold price is cyclical due to the nature of mining. At high gold prices the mining companies generate a lot of cash flow and capital pours into the sector from investors." However for the future, Hathaway expects, "There will be

additional attempts to form regional currencies similar to the euro. For example, the Asian region will establish such a currency. A similar attempt may occur in Latin America and the Islamic world. These currencies will stem from an attempt to displace the dollar, which currently represents 76 percent of world Central Bank reserves. The new currency blocs will reflect trading patterns, national interests, and cultural factors."

Outlook

The present escalations in the current gold prices can be attributed to the following factors: The replacement cost of gold from the mines is about \$400 to \$500 per ounce which is quite higher than the present worldwide prices of the gold. Hathaway says, "As a commodity, gold appears undervalued since the replacement cost of discovering and finding new gold reserves (greenfield basis) is at least \$400/oz. Unless gold trades above this level, mine production is set to decline steadily for years to come." In such a case the investors are expected to be bullish on gold in future also. One of the other factors is that investment in gold serves the purpose of risk diversification, which is more prominent when the market is bullish on gold. More importantly, the global

economy is in trouble due to which lot of investments are heading towards gold, thereby increasing demand for it, since gold is considered to be "asset of the last resort". Opines Hathaway, "The point that most investors fail to pick up on today is that once a market has crashed, it takes a very long time to regain its footing. This was true of Japan during the 1990s and

it will also be true of Western equity markets over the next 10 years. It is during these periods of low returns on financial assets that gold performs best, first because of the lack of alternatives and second because of the potential for financial mischief on the part of political authorities." It is also argued that due to the advent of euro there is a threat to the dollar in future to continue as a single dominant currency for reserves; hence the funds are gradually taking the side of gold which is a more firm and less risky investment. Lastly, the fluctuation in the gold market ought to happen since it is one of the world's highly liquid assets and

"There is a cyclical trend in the ratio of the stock market (as represented by the Dow Industrials) and the gold price. This ratio made long-term peaks in 1929, 1966 and 1999, and long-term bottoms in 1932-1933 and 1980."

Steven A Saville, Editor of The Speculative Investor

till the time the world economy recovers, gold prices are expected to escalate.

Says Hathaway, "Most financial analysts look at the world with rear view mirrors. For them, a gold price of more than \$300/oz seems high because of the preceding 20-year bear market. But the amount of credit created during that 20-year bear market dwarfs anything in history. The amount of gold produced has grown slowly, at less than two percent per year since the price crossed \$800 over 20 years ago. In this context, it would seem quite plausible that the next peak (in US dollar terms), five or 10 years from now, will easily exceed four digits."

In a nutshell, it can be said that the gold prices are inversely related to the dollar prices. Secondly, there is a tendency to pull out money from other sources such as stock market and invest in gold in case of any loss of confidence in the economy. The price of gold rises whenever the inflation rate rises. The prices of gold are affected by any of the short-term and long-term economic forces, which result in affecting any of the factors mentioned above. The dollar gold price is different from the price of world average gold price. The former largely depends on dollar and for the same reason average gold price is higher than dollar gold price currently. The forecast for the future is that the price of gold is expected to rise over the coming years. However, this could happen only if the unwarranted strength of the dollar reduces and the replacement cost of gold is higher than its prevailing price. ■

Related Article:
Falling Gold Prices So far and no more, *Analyst*, May 1999.

Abhishek Agrawal, Team Analyst

Reference # 1-2002-06-08

INTERVIEW

“Market cycles are permanent facts of life but gold has maintained its long-term value. In contrast, most currencies including the US dollar and industrial commodities have generally declined.”

Dr. A S Harish, Manager, The Vysya Bank Ltd., Bangalore

□ Do you subscribe to the fact that both gold and the US dollar are analyzed in a similar manner?

The economic forces that determine the price of gold are different from the price of most financial assets. For example, the price of a stock depends on the earnings and growth potential of the company it represents. Likewise, the price of a bond depends on its safety, its yield, and the yields of competing fixed income investments. The price of gold, however, depends on different factors including the supply and demand for gold, the status of the US dollar, inflation and interest rates. While the effect of these factors on the gold price are somewhat complex, the important point to remember is that they cause the price of gold to move independently of the prices of other assets in a portfolio. National currencies have come and gone throughout history but gold has remained remarkably stable. It is not directly affected by the economic policies of any individual country and it cannot be repudiated or frozen as in the case of paper assets.

□ Unlike gold, the value of the dollar has declined over a long period of time. Against this backdrop, do you feel that over a long period of time gold will regain its acceptance?

Market cycles are permanent facts of life but gold has maintained its long-term value. In contrast, most currencies including the US dollar and industrial commodities have generally declined. As far as, gold regaining its acceptance in the long run, it is appropriate to mention that Central Banks are now selling their gold reserves. Central Banks need reserves; if they have fixed exchange rates or their currencies, since they have to intervene in foreign exchange rates to maintain the fixed parity. But it is not generally thought that even with flexible exchange rates reserves are

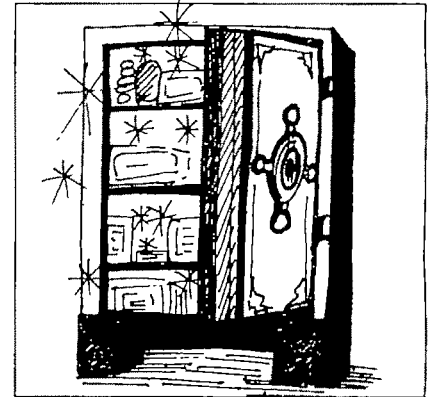
needed. For with a strong undervaluation of the domestic currency, inflation is imported. And a strong overvaluation leads to damaging foreign competition for export and import-competing industries. Therefore, interventions in foreign exchange markets under flexible rates have been the rule rather than the exception. Most of the people are in favor of abolishing gold as a reserve and those selling it have pointed out that there is no return on gold holdings. But they have left out the other question, namely that concerning the safety of reserves. The issue related to the safety of reserves is the strong fluctuations of exchange rates caused by different rates of inflation. It should be obvious that a devaluation caused by higher inflation makes foreign exchange reserves more risky than gold in the long run.

Again, under the so-called new economy, the monetary base is always shrinking as a percentage of money. For instance, let us imagine a scenario where all firms and households are connected with their computers via the Internet to a clearing agency, and are credited and debited when they buy and sell, and that they also enjoy a credit line. In such a system Central Bank money would no longer be needed. In such a situation, the solution for controlling the money supply would be to fix a parity

of the then digital money to a certain unit of gold or a commodity basket. This would provide a much better solution than to exert control with the help of minimum reserve requirements or other regulations.

□ Considering the abundance of dollar compared to gold, do you think that it will lead to a non-acceptance of dollar over a long period of time of about 30-50 years from now.

Presently the US dollar is the world's only international currency. As per the estimate,



around 70 percent of all the greenback notes that are produced circulate outside the US. Ninety percent of all commodities are invoiced in dollars; 90 percent of all foreign exchange transactions have the dollar on one side of the trade. The manufacturing invoicing picture is not as clear, but approximately 40 percent of all exports from Japan are invoiced in US dollars, and approximately 70 percent of all imports into Japan are invoiced in dollars. Approximately, 61 percent of all foreign reserves in Central Banks are denominated in US dollars. The euro is the largest regional currency in the world, but it is not an international currency, and for it to become an international currency depends on something happening to Fed policy and the quality of the dollar. It is in this context, that it is important to distinguish between the status of gold as a reserve asset and its potential as a currency anchor.

□ What change do you foresee in the global currency system in the next (a) 10-20 years period, (b) 40-50 years period, given the history of the present currency system?

The advent of the euro is a very important event in the international monetary system, indeed, it is the most important event since the breakdown of the gold exchange standard in 1971. In a way, it has another dimension of importance in view of the combination of several large countries and many small

National currencies have come and gone, but gold has remained remarkably stable. It is not directly affected by the economic policies of any individual country

countries into one currency zone creating the potential for a change in the power configuration of the international monetary system. Thus, with more and more countries accepting the euro as their currency may result in a combined GDP that is probably larger than the US GDP. Thus, with this weight in the system, the monetary mass in the euro zone in years to come will be larger than the dollar area subject to the dollar area going to remain constant. Another dimension to the dynamics of dollar and euro concerns the Asian region and the need for a common currency in the Asian region. Though it is somewhat true that Asia needs a common currency, it is not possible like Europe. Asia might develop a common, parallel currency, but it is certainly not going to develop a single currency, because that involves a political commitment that the Asian countries are not yet ready for. Nevertheless, this is the new landscape that we see around us. Thus, looking around us at the world today, the situation is that there are three important currency areas. The dollar area is the biggest area; the euro area is second, and the Asian countries are third.

Anything that has to do with reform of the international financial architecture has to deal, not only with the peripheral aspects of the system, but also with the core workings of exchange rates in these three areas. These three areas have a high degree of price stability. Inflation in the dollar and euro zones is less than three

percent, and the inflation rate in Japan is close to zero. They are three zones of stability, but between them there is instability, with large potential fluctuations in the exchange rate. If there are big differences in inflation rates, they will have an impact on fluctuations in exchange rates. There is no need, however, for fluctuations in exchange rates between areas that have the same degree of price stability. Today foreign exchange markets are approaching \$1.5-2.00 per day in cross-border transactions. If the entire world used a single currency, the level of foreign exchange transactions would be zero.

□ How do you correlate gold prices with inflation?

Gold continues to have an important role to play in the management of global reserves.

Gold, which performed monetary function for years, can still contribute, in the decades ahead, preserving the fundamental condition of orderly economic activity—price stability. The experience of the period following the Second World War shows that macroeconomic stabilization has always provided the basis for the growth of the most successful economies. Conserving this stability and the soundness of economies' fundamentals is one of the principal tasks of governments and Central Banks.

The steady decline in gold prices in recent years against the background of low inflation raised doubts in some quarters, on the importance of gold as a safe investment and hedge against inflation. Some Central Banks have resorted to off loading substantial quantities of gold, which they held as reserves. Another significant development of the 1990s was the spurt in Central Bank lending of the precious metal. Central Banks are lending their idle stocks with a view to enhance returns on reserves, which is bringing in good liquidity to the market to bridge the gap between supply and demand. A notable development in this

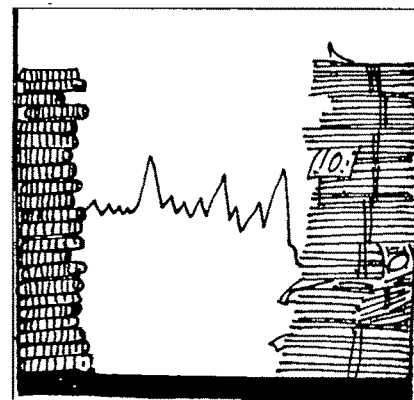
regard is the signing of the Washington Agreement by some Central Banks in September 1999, which has placed an effective cap on such operations of Central Banks.

The gold reserves of the Central Banks today amount to some 32,000 tons, about one quarter of the world stock. Like other real assets, gold can appreciate when there is widespread inflation, which

remains a threat. Gold's importance as a monetary anchor came to an end with the emergence of more rigorous monetary policies in the 1980s and especially the 1990s. But in periods of crisis gold can constitute a sort of reserve or guarantee "of last resort" for a country.

□ Would you like to share anything more on the relationship between gold prices and exchange rates?

As of now, official reserves are constituted approximately 66 percent in dollars, and approximately 13 percent in DM/euro, but yen holdings are actually only five percent of official reserves now, and falling, while sterling is four percent and rising. Gold should be held in reserves for long-term purposes, not just to maximize short-term returns but from



liquidity considerations. Gold has some kind of psychological attachment and viewed as a symbol of stability.

The rationale for holding Gold despite its non-interest bearing nature (there has been no official role for gold since the collapse of the gold exchange standard) is the overriding quality of gold. The absence of any credit risk is an intrinsic quality of gold, it offers full security as long as it is properly stored in Central Bank's vaults. Gold is nobody else's liability, and it is the only financial asset with that quality. The second characteristic is liquidity. Particularly, in times of global turmoil or high global inflation, gold is unchallenged. Certainly in circumstances of orderly financial markets, gold is not the most liquid of assets even though it is probably the most liquid of commodities. Gold's liquidity becomes more apparent and increases as uncertainty grows. In this regard, the absence of a substantial return on gold is compensated by liquidity factor. Contrary to most other assets, gold prices go up when things really go wrong. Finally, the third motivation for holding gold is diversification. Gold is also a good diversification instrument; in the long run, the price of gold has shown a very low, or even negative correlation with the dollar and a negative correlation with US treasuries as well. From this standpoint, gold in a diversified portfolio allows to improve risk-return profile.

Recent market developments have, in no way, altered its intrinsic qualities. There is still a rationale for Central Banks to hold gold. Gold can be considered as an insurance policy for large countries. Like any insurance mechanism, it has a cost. The cost of carrying. A parallel can be drawn, concerning countries, maintaining an army even during peacetime.

(The views expressed herein are the personal views of the author)

CASE STUDY

Xerox Corporation

Documenting problems

In the continuing saga of accounting frauds, Xerox is the latest to come to the fore. The copier giant, however, got off the hook by agreeing to pay the largest fine ever for financial fraud but without admitting or denying the wrongdoing. Xerox is now bracing itself for the tough challenges ahead while trying to portray its accounting woes as a thing of past.

Xerox Corporation, a Stamford, Connecticut-based public company, had an unorthodox but effective way of meeting or beating analysts' earnings forecasts in the late 1990s. When operating results looked as if they would fall short, which often was the case, because the US office equipment giant was struggling to adapt to a more competitive market for its copiers—executives would “close the gap” using one-off accounting tricks. That is the central allegation—neither admitted nor denied by the company—of the Securities and Exchange Commission's recent complaint against Xerox, a case that its officials say is one of the largest financial frauds they have seen. With widened probe, for a while, it looked as if Enron and Andersen will be pushed out of the headlines by Xerox and KPMG.

The Xerox web

James Bingham, an assistant treasurer of Xerox was fired in August 2000 when he complained about the accounting tricks that the copier company was using to boost its flagging earnings. He alleged that the accounting woes of Xerox were largely because of a culture in which managers were under intense pressure to “stretch” financial targets and then to reach them. And the compensation was related to managers meeting the earning expectations. Such a culture is by no means unique to the now distressed copier company. Many firms, pushed to reach unrealistic targets in these tough times, are tempted to manage their numbers too, sometimes within the law but on occasions, also outside it.

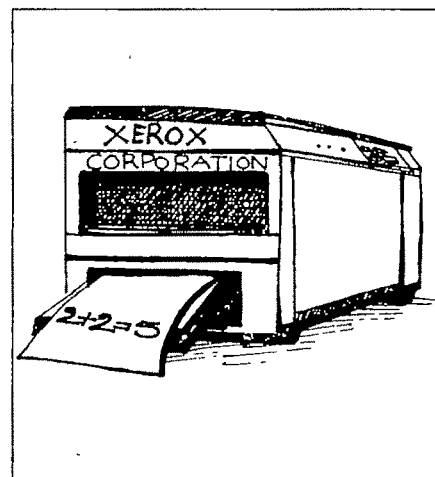
The troubles at Xerox started out in late 2000, with the advent of a simple

investigation of accounting practices at the company's Mexican operations. But that investigation sparked off a firestorm of controversy about Xerox's accounting practices. And the company has seen its reputation nosedive after being imposed by Securities and Exchange Commission (SEC), a fine of \$10 mn, the largest for financial fraud against any public company, and agreed to restate its earnings. Xerox was able to settle the two-year-long case on April 11, 2002, on the day when it was filed and resolved all the pending issues with SEC without requiring to admit to the wrongdoing. Xerox settled the case with SEC by agreeing to pay the record fine, and restate the results for the years 1997 through 2000 and also agreed to appoint a committee composed entirely of outside directors to review the company's accounting controls and policies. This will be Xerox's second restatement. Last June, it restated results for 1998-2000, saying that it had “misapplied” certain accounting rules.

Many firms, pushed to reach unrealistic targets in these tough times, are tempted to manage their numbers too, sometimes within the law but on occasions, also outside it

Comments Partha Mohanram, Associate Professor of Accounting at Stern School of Business, “Even though technically no wrongdoing has been admitted, the firm is guilty for all practical purposes. In this case this was probably the best, because any proceedings would have dragged on forever and diverted resources that would be better spent ferreting other such abuses at other firms. Xerox's reputation is in tatters and one can be pretty sure that they will be conservative in their accounting, as any aggressive accounting by them will be discounted for its low credibility.”

But SEC is continuing its investigation as it concerns other parties, and has sent “Wells notices” (that function as a



warning and provides recipients the opportunity to explain to the SEC why an investigation is not justified) to top executives at the copier giant and KPMG, its former auditor. As the lead KPMG partner on the account, Michael Conway, received one such notice. So did former Xerox chairman Paul Allaire and ex-CFO Barry Romeril. Until receiving a formal notice from the SEC, Conway was rumored to be a leading candidate to become the next chairman of the Financial Accounting Standards Board. The fact that Conway got such a notice could be enough to derail his candidacy for the post.

KPMG, the auditor of Xerox for about 30 years was replaced with PricewaterhouseCoopers in October 2001 without specifying any reasons. KPMG, on the other hand, claims, that it was actually fired for standing up against its clients. This argument, however, does not seem to hold water as it was fired much after the fudging of numbers first came to light in 1997.

As Robert A Howell, a business consultant, with wide experience as an academician at the Tuck School of Business at Dartmouth, Stern and Harvard Business Schools puts it, “KPMG

should have focused on the revenue recognition issue, e.g., the distinction between product and service, and the timing of each. If they discussed it, and let it go, they are in deeper trouble, and should be held accountable." But Mohanram says, "In any case, auditors are to be blamed in all these issues, but only partially. In a crazy market (2000) that was fixated on top line numbers, firms used all kinds of accounting gimmicks that were borderline legal/illegal to push up revenues and sometimes income—even if cash flows were unaffected. With complex multi-year contracts, revenue recognition has always been an issue. In the light of these, Xerox's transgressions seem minor in comparison."

KPMG finding itself a target said that it is "bewildered" to find itself in the "hot seat". "Our position, generally, is that we did the right thing in this case, we served our role as independent auditors ... (and) took difficult, tough positions with our client. KPMG did everything an auditor is supposed to do and more to make sure the investor is protected." Regarding the cases against individuals, Howell says that the SEC, or Justice Department, should go after the Board, executives, and audit firm for significant restitution, and possible jail time.

Accounting shenanigans

The SEC's complaint alleged that from 1997 to 2000, Xerox used a host of undisclosed "accounting actions" to meet or exceed Wall Street expectations and mask its true operating performance from investors. It was the earning expectations that were driving the reported earnings and not the performance. "Xerox used its accounting to burnish and distort operating results rather than to describe them accurately," said SEC in the complaint. "For Xerox, the accounting function was just another revenue source and profit opportunity. As a result, investors were misled and betrayed." The accounting actions, which Xerox called "one-time actions," "one-offs," "accounting tricks" and "accounting opportunities," were an off-shoot of a four-year scheme orchestrated by the senior management to "close the gap" in Xerox's parlance, between the company's operating results and the

market's expectations from 1997 through 2000.

On April 11, 2002, the SEC filed a civil fraud injunctive action, alleging that from at least 1997 through 2000, Xerox employed a variety of undisclosed accounting actions to disguise its true operating performance from investors. These actions, most of which violated Generally Accepted Accounting Principles (GAAP), accelerated Xerox's recognition of equipment revenue by over \$3 bn and increased its pre-tax earnings by approximately \$1.5 bn over the four-year period from 1997 through 2000.

The complaint alleged that these accounting actions had a substantial impact on Xerox's reported performance. For example, in the fourth quarters of both 1998 and 1999, accounting actions generated 37 percent of Xerox's reported pre-tax profit. Further by 1998, nearly \$3 of every \$10 of Xerox's annual reported pre-tax earnings resulted from undisclosed accounting actions. Without these accounting actions, Xerox would have fallen short of market earnings expectations in virtually every reporting period from 1997 through 1999.

The allegations in the complaint centered around seven different accounting actions that Xerox used to manage Wall Street pressure. Many of these actions accelerated Xerox's recognition of revenue into current periods at the expense of future periods.

Xerox concealed these actions and the investors remained unaware that the company was meeting earnings expectations only by using accounting maneuvers that could compromise future results.

Several of these accounting actions related to Xerox's leasing arrangements. Under these arrangements, the revenue stream from

Xerox's customer leases typically had three components: The value of the equipment (which internally Xerox refers to as "box"); revenue that Xerox received for servicing the equipment over the life of the lease; and financing revenue that Xerox received on loans to its lessees. Under GAAP, Xerox was required to book revenue from the "box" at the beginning of the lease, but was required to book revenue from servicing and

"Once a company moves earnings from one period to another, operating shortfalls that occur thereafter require it to engage in further accounting maneuvers that must be even more 'heroic'. These can turn fudging into fraud."

*Warren Buffett, CEO,
Berkshire Hathaway*

financing over the course of the lease period. Xerox resorted to accounting actions to shift more lease revenue to the "box", so that a greater portion of that revenue could be recognized immediately.

SEC alleged that two accounting actions with the largest impact on Xerox's financial statements were methodologies that Xerox called "Return On Equity" (ROE) and "margin normalization". Xerox used the ROE method to attribute revenue to equipment that the company historically had allocated to financing. From 1995 through 2000, Xerox based its earning reports on its assumption of a 15 percent ROE for determining the finance component of its sales-type leases. Between 1997 and 2000, Xerox continually depressed its estimate of the fair value of financing, thereby increasing its reported equipment revenues. It did this by expanding its ROE method to new geographic areas and through strategically timed changes in the factors and assumptions used to calculate the lease interest rate that would produce a 15 percent ROE. In other periods, Xerox adopted or changed assumptions used to estimate the interest rate required to produce a 15 percent ROE, such as the appropriate effective tax rate, debt-to-equity ratio, administrative cost allocation, and the tax timing benefits. As a result of these continuing changes, more and more income was shifted to the equipment.

Margin normalization shifted revenue to equipment that historically had been allocated to servicing. As a result of intense price competition in the 1990s, as foreign manufacturers grew increasingly sophisticated and in some instances beat Xerox to the market with color and digital copying technologies,

For Xerox, the accounting function was just another revenue source and profit opportunity. As a result, investors were misled and betrayed

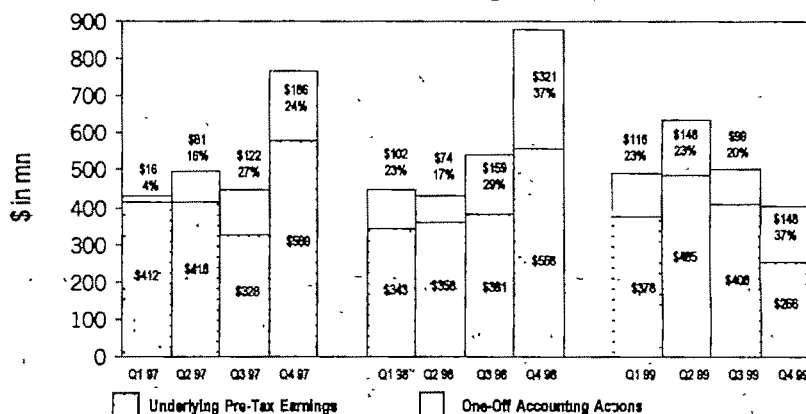
margins on Xerox equipment declined especially outside the United States, while service margins remained stable. Instead of disclosing this as a cause of reduced equipment margins, Xerox reallocated revenue from service to the "box" based on an assumed gross margin differential between service and the "box". Margin normalization, like KOE, was a top-side adjustment made by Xerox near the end of reporting periods. Sales and allocation of revenues were initially booked by operating units, which did not use margin normalization. Then, on a consolidated level, management reallocated Xerox even made these reallocations retroactively to transactions that had already been reported in its financial statements.

These two methodologies, which did not comply with GAAP, increased Xerox's equipment revenues by \$2.8 bn and its pre-tax earnings by \$660 mn from 1997 to 2000. Xerox also used approximately \$1 bn of additional accounting actions to artificially improve its operating results. These additional actions included the improper use of "cushion" or "cookie jar" reserves. It pumped up its earnings by nearly \$500 mn through the release into income of excess or "cushion" reserves originally established for some other purpose and released into income approximately 20 other excess reserves totaling \$396 mn to improve its earnings from 1997 through 2000.

The aftermath

Although the restatement and fine are manageable and most analysts rate the stock as hold, near term outlook is gloomy. The restatement will primarily reflect adjustments in the timing and allocation of lease revenue and could involve a reallocation of equipment sales revenue in excess of \$2 bn from 1997 through 2000. While Xerox's sales figures for the individual years will change as a result of the restatement, the aggregate of the revenues for all years in question will remain unaffected. As only the timing of revenue recognition was in question, and not the amount because Xerox artificially inflated sales and income from 1997 to 1999, the restatement will reduce revenue for those years and boost stated revenues for 2000 and 2001.

Impact of "One-Off" Accounting Actions on Pre-Tax Earnings for the Quarters During 1997-1999



Most analysts didn't change their earnings estimates after the SEC fine was announced. Christa Carone, Director, Corporate Public Relations, Xerox Corporation says "The restatements that are now being processed primarily reflect changes in the timing and allocation of revenue. There is no change to the actual amount of revenue that was received over the period of 1997-2001. There is no impact on cash received or contractually due to be received." Moreover, the restatement should also boost Xerox's 2002 and 2003 revenues as it was still

booking revenue upfront in 2000 for typical four-year equipment leases, but that revenue will now be booked over the four-year period, which includes this year and next.

Initially, Xerox resorted to these accounting actions to add only a penny or two to quarterly earnings to meet Wall Street estimates. However, as Xerox found it increasingly difficult to

meet quarterly analyst estimates through operations, reliance on "one-offs" became more pronounced and accounted for a growing percentage of reported earnings.

As Warren Buffett, CEO, Berkshire Hathaway, Omaha puts it, "Once a company moves earnings from one period to another, operating shortfalls that occur thereafter require it to engage in further accounting maneuvers that must be even more 'heroic.' These can turn, fudging into fraud." At first corporate deceivers do not break the law, but eventually they find that corporate

deceit is difficult to sustain. Deceit demands more deceit until eventually the pile collapses under the weight of its own unsustainable schemes.

However, Xerox has been able to come out of the accounting scandal successfully. As reflected in the words of the company's CEO, Anne Mulcahy, in her speech to the Chief Executives Club, Boston, "As far as I'm concerned, the SEC issues are behind us. We have settled and we are moving on. There is not a lot I can do about the past—or the residual press coverage." Adds Carone, "Putting this issue behind us is in the best interest of Xerox and our key stakeholders. It was a difficult and bold decision...but one that will serve Xerox well in the long-term."

Bracing for a tough future

The SEC fine, restatement and damaged reputation are not the only problems that Xerox is facing now. The biggest immediate problem is to refinance the \$7 bn loan and another possible snag could be expensive and time-consuming shareholder suits linked to SEC case.

The restatement of financial statements—in a period in which Xerox was a hot stock, could open the door to lawsuits by shareholders. In the beginning of 1997, Xerox shares traded around \$28 (adjusted for splits). They climbed as high as \$60 in the beginning of 1999, before starting a steady march down to less than \$5 at the end of 2000. However, shares have now gained a bit, but continue to be volatile, since then. Xerox's market value is down by 90 percent or \$40 bn in the past two years. While Xerox certainly faced other important operational problems, which

Corporate deceivers do not break the law, but eventually they find that corporate deceit is difficult to sustain. Deceit demands more deceit until eventually the pile collapses.

drove both the run-up and the decline, investors who bought shares in the end of its golden days could claim substantial damages. However, they will have to prove that Xerox was willful or negligent in how it reported its income. But Carone says that, "Xerox's settlement with the SEC does not change the company's view on the outstanding litigation as Xerox has neither admitted nor denied the SEC's claims and Xerox intends to vigorously defend itself in these cases."

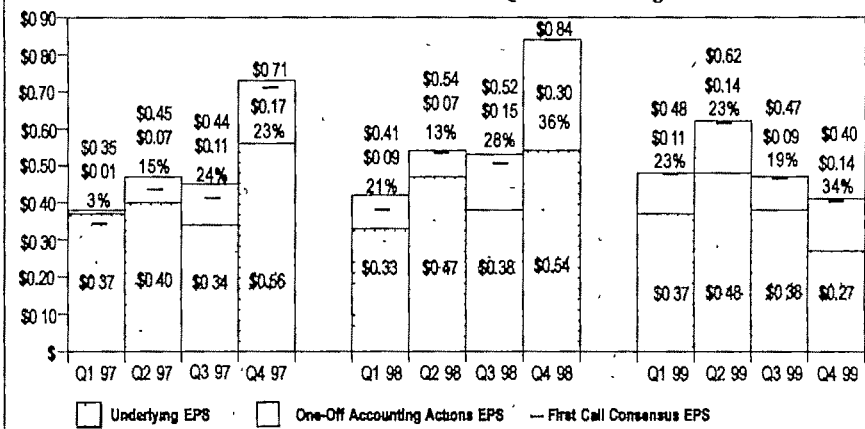
A key hurdle faced by the office equipment giant as it works to restore its fiscal health is refinancing of debt revolver that is due in October 2002. It would be forced to file for bankruptcy if it fails to convince its bank group consisting of 57 banks that are involved in the revolver. Moody has downgraded the company's bonds rating, which were already in junk territory, by as many as four notches, citing concerns about debt relative to free cash flow. Fitch has also lowered its rating outlook from stable to negative. The ratings changes, which will increase the copier maker's borrowing costs, affect about \$9 bn of debt. The ratings considered the company's weakened credit protection measures, refinancing risk of the revolver, significant debt maturities for the next three years, the competitive nature of the printing industry, the necessity for constant new product introductions, and overall weak economic conditions.

Though there may not be any problem in getting the refinancing, the downgrade may increase the borrowing cost and may cause banks to place restrictive covenants on Xerox. As echoed in Carone's words, "Xerox is on track to complete its negotiations with revolver lenders no later than the end of June. There is no doubt at all that this commitment will be met. Xerox is paying down a portion of its \$7 bn revolver and refinancing the remainder. This is a win-win for Xerox and its lenders and there is absolutely no uncertainty in the parties' ability to complete these negotiations in a timely manner."

The company is fundamentally different from what it was two years ago and the future for the world's, largest copier company looks robust. It has made significant progress with its turnaround strategy as the previously announced \$1

If Xerox can get the banks to renegotiate its debt, and impress customers with its new products, investors might have something to look forward to.

Impact of "One-Off" Accounting Actions on Reported EPS and Comparison to First Call Consensus Estimates for the Quarters during 1997-1999



bn cost-cutting program was achieved ahead of schedule and was larger than anticipated, including a more than 10 percent reduction of workforce from year-end 2000. Asset sales have totaled more than \$2.0 bn, including an agreement to outsource approximately half of its manufacturing, the common stock dividend has been eliminated, and the company has exited businesses that puffed up its market share but did not do much for the bottom line. A year and a half ago, the company teetered on the

brink of bankruptcy and since then, it has reduced its workforce by more than 13,000, bolstered cash to \$4.5 bn—including the recent sale of \$746 mn in senior notes—sold non-strategic assets and found partners for others. As Carone, optimistic about the future, puts it, "Xerox's new management team is continuously working towards making the company better and year 2002 will be one of Xerox's biggest years in terms of new technology and services as they are about to launch five new product platforms."

There are indications that the fundamental business is improving. As revenues are forecasted to range from flat to down, it is crucial that Xerox continues its cost-cutting programs in order to return the core operations to consistent profitability levels. Cash flows remain strained and will have to increase significantly in order to meet debt obligations. The company has about \$2.4 bn of other obligations maturing this year and \$2.9 bn in fiscal 2003. However, economic weakness and diminished

capital spending levels have reduced Xerox's prospects for significant improvement in revenue growth and debt protection measures in the near term. The economy would be the largest factor, as the color-production segment is associated with high-end machines.

Chastened Xerox?

"Again, let us not make an Enron out of Xerox. The stock is down to \$8 from \$10. That it was at \$10 from \$40-50 before, owes more to real problems facing the firm than any accounting problems. This is basically a fundamentally sound company that was over aggressive in its accounting. There are no shady related party transactions or market manipulating activity here," says Mohanram. Xerox will soon hire an independent consultant to review its accounting policies. If Xerox can get the banks to renegotiate its debt, and impress customers with its new products, investors might have something to look forward to. Of course, the question for investors is how much of upside Xerox has. Will Mulcahy be able to reduce expenses further, introduce new and compelling products and convince investors that its name is not permanently tainted? Xerox may be one of the lucky ones and remain a "market-share leader in high-volume segment and boast of being the industry's largest sales and service organization." ■

Related Articles:

1. Andersen: Credibility at stake, *Analyst*, February 2002, Reprint # 1-2002-02-06
2. Eruption of Mount Andersen, *Analyst*, April 2002, Reference # 1-2002-04-04.

A Sowdeepi, Team Analyst

Reference # 1-2002-06-10

FINANCIAL MARKETS

Catastrophe Bonds

CATS out of the bag

Recent disastrous events like the 9/11 incident have given the catastrophe bonds a new lease of life. They have become so popular that they are seriously being viewed as alternatives to reinsurance. These instruments are now reshaping the insurance industry.

The events of September 11 have affected businesses in more ways than one. Nowhere was the impact more intensely felt than in the insurance industry. The insurance claims were in billions of dollars and the reinsurers were counting their bills. The insurance rates surged and this turmoil seems to have given a fresh lease of life to the catastrophe bonds.

Catastrophe bonds (or CAT Bonds, as they are called) are instruments issued usually by the reinsurers to hedge a part of the risk they bear. Part or the whole of the principal may be refundable in nature. This means the investor may not get back part or whole of the principal. If the principal is protected or secured, then the investor will get back the money after the tenure of the bond. Usually, a part of the principal is variable and a part is protected. The coupons are also different. The coupon on the protected part is lower compared to the variable part.

The returns for the investor depends on whether a particular catastrophe occurs or not. Thus for example, an investor may receive a 10 percent coupon and the entire principal if there is no hurricane or earthquake. However, if an earthquake does occur, then the investor may get (say) 5 percent coupon, and only half of the principal. In the extreme case, the investor may not get back anything at all.

Simply put catastrophe bonds work like this. An insurer creates a trust account, enters into a reinsurance contract with a third party and simultaneously issues catastrophe bonds to the investors. In the event of non-occurrence of any catastrophe, investors receive their investment back with an interest that compensates them

suitably for the interest sunk in such bonds. On the other hand, if a catastrophe does occur investors lose the entire principal and the funds are transferred to the insured.

Risk-return profile

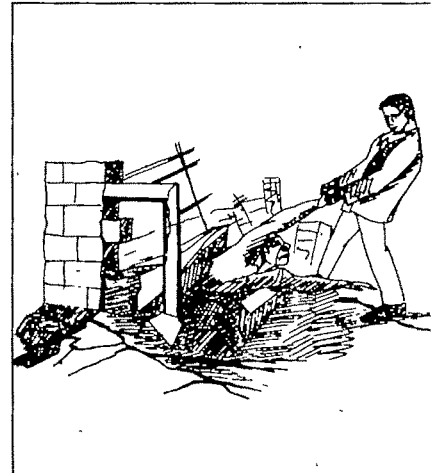
What are the risks and return of this particular instrument? If one studies the catastrophe bonds properly one will realize that its beta (market risk) is zero. Its pay-offs are not correlated with the market at all. If an investor buys a catastrophe bond his entire risk is non-systematic in nature.

Coming to the returns side the expected return on such bond should be exactly equal to the risk-free rate of return. If catastrophe bonds are issued with the same expected pay-off as a risk-free treasury bond gives, then no risk-averse investor will invest in such bonds. Because of imperfections in the reinsurance market, the risk premiums on such bonds turn out to be positive.

Catastrophe bond is a fixed income investment vehicle that can have very high investment ratings and hence make the investment grade, which weather derivatives can never do

So are the catastrophe bonds similar to the more talked about weather derivatives? Jose Penalva, Faculty, Finance and Insurance, University of Pompeu Fabra, Barcelona, Spain, clarifies, "In the case of an earthquake both are quite similar but they are not similar in case of hurricanes and windstorms.

Technically, a catastrophe bond is a fixed income investment vehicle that can have very high investment ratings and hence make the investment grade, which weather derivatives can never do. On the underlying in the contract, you could consider a similarity in that a hurricane or windstorm cat bond is a kind of out-of-the-money option on wind speed and rainfall levels. Nevertheless, the low probability nature of cat bond trigger



events requires a different methodology than the one used for weather derivatives."

Pitabas Mohanty, Professor, T A Pai Management Institute echoes the same with an example. He explains "Weather derivatives help one in hedging against certain weather related events. Suppose there is a five-star hotel in a hill station. The number of tourists depend on the weather at the hill station. If the temperature is above, say, 45°C (or if the rainfall is above certain level, etc.), then the buyer of the weather derivative (in this case the hotel) can get compensated. Suppose, the hotel gets very few tourists when the temperature is above 45°C. I can compensate itself by buying a call option, for example. The call will get activated if the temperature rises to a level higher than 45°C. Then the buyer of the call will get compensated as per a predetermined formulae. There is some similarity between weather derivatives and cat bonds. However, they differ in terms of the nature of the buyers and sellers, the pay-off function, etc."

Greenhouse not Greenspan

These catastrophe bonds have certain unique characteristics, which differentiate

them from the other financial instruments. The prices of these bonds seem to depend more on the greenhouse rather than on Greenspan. These instruments are not affected by the change in interest rates nor the volatility of the stock prices. Further, they are also not affected by whether the economies are in recession or are coming out of it. As mentioned earlier these are the zero beta instruments, which have no correlation with the stock market index or the interest rates. The yield on these instruments varies depending on the nature of disaster and the severity of it. They normally carry a interest of 300 to 500 basis points above the LIBOR

So who are the issuers and investors of catastrophe bonds? Technically, anybody can invest in catastrophe bonds. But usually large institutional investors invest in catastrophe bonds. When catastrophe bonds were first issued in the US, the Securities Exchange Commission raised certain objections to individuals' buying catastrophe bonds.

It is imperative to understand that anybody who is buying the catastrophe bond is actually providing insurance services to the reinsurer or the insurer (as the case may be). But as per the law, only certain institutions with certain minimum net worth and with a proper license can provide insurance service. Therefore, an individual or a mutual fund cannot buy these catastrophe bonds. However, SEC subsequently relented and allowed the normal investors to buy catastrophe bonds.

The basic motive behind buying a catastrophe bond is risk diversification. Since the beta of a catastrophe bond is zero it provides tremendous scope for risk diversification.

Mostly insurers and (or) reinsurers issue catastrophe bonds. The basic motive behind issuing catastrophe bonds is that the transaction costs are lower compared to reinsurance. Catastrophic events (when they occur) cause substantial loss to the insurer. Catastrophes may even disrupt the entire insurance market. Because of the large amount of money involved, the market for such risks is very thin. This inflates the insurance loading. The loading is substantially higher than the expected loss from the catastrophe event. Since the capital market has more depth, the reinsurance company can get the required fund by incurring lower transaction costs.

All About Catastrophe Bonds

• Risk and return in investing in catastrophe bonds

Catastrophe bonds are debt contracts issued by special purpose vehicles (shell companies whose only real purpose is to hold claims on assets and issue debt/equity against those assets). The assets they hold are the capital raised via the debt issue plus contributions from the insurance/reinsurance company behind the contract. The return to holders of the debt is the return of their investment plus an above market return (their initial investment plus the contributions from the insurance company) if there is no triggering event or catastrophe. The risk, of course, is the occurrence of a triggering event, which by construction, should be quite rare. In general, the definition of a catastrophe has been the occurrence of either one or a number of large catastrophic events, such as earthquakes, hurricanes, large windstorms, ... The definition of large has been either physical (Richter scale magnitude, epicenter location, and depth, for earthquakes, wind speed, and landfall location for hurricanes) or financial (dollar losses for the industry or a particular company generated by the event).

• Investors and issuers of catastrophe bonds

In general, investors are large funds with a very diversified portfolio in fixed income and the occasional hedge fund. Issuers are large insurance companies. The motives behind these issues are varied but primarily tend to be related to the search and encouragement of alternative sources of reinsurance cover and ways for capital to enter the reinsurance market to lower reinsurance costs.

• Catastrophe bonds and reinsurance industry

An insurance company can issue catastrophe bonds and it certainly can look at such bonds as alternative to reinsurance. The reinsurers generally charge very high loading to insure against any risk with very high-expected loss. A paper by Kenneth Froot in the *Journal of Financial Economics* (2001) shows that the premiums are much higher than the expected losses. This also discourages purchase of reinsurance by the insurers. The costs associated with issuing catastrophe bonds are much lower than the costs associated with reinsurance. Therefore, the emergence of cat bonds will help in making the reinsurance market more competitive.

Catastrophe bonds are an alternative source of hedging for the insurance companies. Since the depth in the catastrophe bonds will always be higher than the reinsurance market particularly at the higher end of the reinsurance market, catastrophe bonds will provide the much needed competition in the reinsurance market.

Instruments for catastrophe

Why are the insurers looking for alternatives to reinsurance when that model has served them for many years? Reinsurance model though simple and flexible has some inherent drawbacks like the possibility of the reinsurer defaulting. This happens in the event of a large catastrophe and the loss suffered by the reinsurer is beyond his capitalized quantum.

The problem of moral hazard is also inherent. Once the insurer is through with the reinsurer there is no incentive for him to exercise due diligence. As the reinsurance contracts involve a set of

transactions, a time delay exists in settling the claims. In the case of Indian insurance companies there are other specific problems. As the reinsurers are all based abroad the premium is affected by the international events.

On the other hand, in the case of the catastrophe bonds the default risk is eliminated. This is because cash is collected upfront and put in an escrow account. It opens the window to the huge capital market, which enables access to enormous funds. It also eliminates the transaction costs associated with syndication of reinsurance. Effectively, individual

CATASTROPHE BONDS

insurers can use the approach to securitize catastrophe risk and obtain finance to meet their unique needs.

Reshaping the insurance business

Driven by the positive attributes, the catastrophe bonds could reshape the insurance business. The catastrophe bonds especially the one-year instruments have become a huge hit with the investors. Typically the reinsurance business goes through boom and bust cycles. Managing a catastrophe risk is a nightmare. When a wave of disasters takes place it depletes the reinsurance companies of their capital leaving no other alternative but to jack up the premiums. And after the disaster prone years give way to the disaster free years the reinsurers replenish their capital and a price war starts among the reinsurer leading to a fall in the reinsurance prices. Normally, the disaster prone years are the time when the popularity of catastrophe bonds skyrocket.

This is the time when the reinsurers charge high premiums, hence insurers looking for a cheaper alternative go for catastrophe bonds. In this way the price volatility would moderate. Some even feel that this might lead to a shake-out in the reinsurance industry with some of them morphing into intermediaries or consultants in the area of risk management strategies.

What was the effect of the September 11 incident on the insurance industry and specifically to the catastrophe bonds? Pitabas Mohanty underlines the role played by psychology in case of such catastrophe. He echoes the statement of the psychologists "Whenever a very unlikely event occurs, the market revises its expectation of such events occurring again in future. Thus for example, assume that the probability that there will be a WTC-like attack is 0.000001. People give more weightage to the more recent events while forming expectations of the future. Therefore, if a WTC-like event occurs, they increase the probability associated with such events." The September 11 incident was just the silver bullet for the catastrophe bonds. With the reinsurance premiums shooting up, the yield on the catastrophe bonds increased, making them more expensive. But they

still remained cheaper compared to the reinsurance."

Jose agrees that the catastrophe bonds cushion insurers but are alarming the reinsurers because they are increasingly being seen as alternatives to reinsurance. He says "Technically, a catastrophe bond is a way for an insurance company to purchase reinsurance directly from capital markets so that the comment is well justified. On more practical terms, the issue of cat bonds is a relatively expensive endeavor so that reinsurance companies have a competitive cost advantage, better methods for evaluation and more experience. It may turn out that cat bonds end up being used by small reinsurers to increase their risk capacity and exploit their experience and knowledge. Regardless of how reinsurers feel about them, cat bonds should increase competition and capacity in the reinsurance market resulting in lower reinsurance costs."

The catastrophe bonds cushion insurers but are alarming the reinsurers because they are increasingly being seen as alternatives to reinsurance

Investors were also more than willing to invest in catastrophe bonds. The series of Federal rate cuts made the investors and portfolio managers hungry for securities that would enable getting higher returns without substantial increase in the risk exposure. This made them look towards

catastrophe bonds.

CATS in India

What about the suitability of catastrophe bonds in India? India has to go a long way before these instruments can even be introduced. Development of these instruments requires sophisticated analysis of non-financial data and involvement of meteorological and other agencies is a must to develop suitable models that facilitate measurement of risk. In the West the models have been created to measure risk. Even the investors need to be educated about the risks and rewards.

The market sophistication required for such instruments is awfully inadequate. The derivative market in India is still in nascent stages. The insurance industry is just been liberalized. Professionals and reinsurance agencies are non-existent. The regulatory environment is also uncertain. Even now securitization does not enjoy a legal

status in India. Stamp duty is very high. The accounting and tax treatment is also not clear. Changes in the Transfer of Property Act is necessary to facilitate transfer of future receivables. But steps like reduction in stamp duty by some states and formation of a committee by SEBI to study the disclosure requirements are steps in the right direction.

Pitabas Mohanty sums up some of the problems which the insurer or a reinsurer would face in issuing catastrophe bonds. Catastrophe bonds are very complicated instruments. Pricing such bonds is a very difficult exercise. Therefore, investors may find the product too complex to handle. Therefore, a lot of investor education is required in the beginning. The rating agencies may also find it difficult to rate it in the beginning. Of course, both S&P and Moody's rate catastrophe bonds in the US, and therefore, ICRA and CRISIL (both of which have partnership with the US agencies) may be able to surmount this problem.

Finally, as per the IRDA Act only certain companies can provide insurance in India. IRDA may raise the same objections in India that the SEC raised in the US in the beginning. An investor of a catastrophe bond actually provides insurance to the issuer of the catastrophe bond. But the IRDA Act does not allow every body to sell insurance in India. In the strict sense, therefore, issuing of catastrophe bonds may not be legally possible.

Balancing opposite requirements

The success of a catastrophe bonds lies in satisfying two opposite requirements. The cost relative to the reinsurance must be low enough to attract the issuers. Yet they must be set high enough to provide attractive returns to potential investors. This would be a very difficult balancing act. There is no doubt that the catastrophe bonds have been able to perform the balancing act. This has increased the popularity of these bonds. Catastrophe bonds would not replace the reinsurers but would rather complement them. ■

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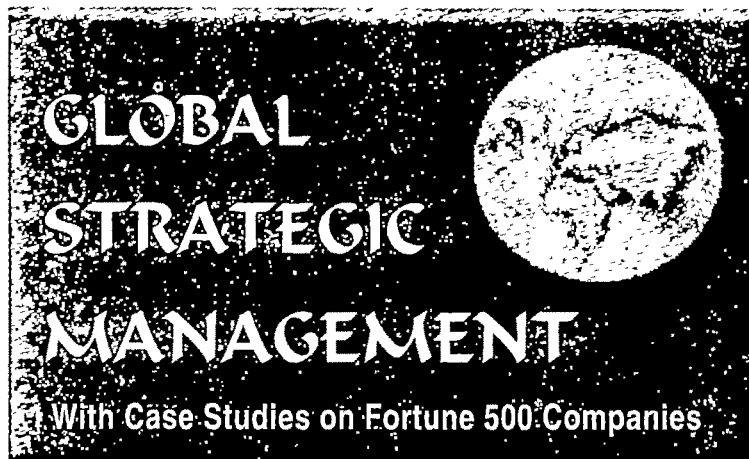
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BUSINESS ENVIRONMENT

Family Businesses

Transformation challenges

Family-run businesses are moving towards third-generation ownership which is the most critical phase for their survival. To survive in the competitive environment, they must introduce best practices and lay down clear rules on governance and leadership.

Corporate India is synonymous with big family-run business houses like Tata, Birla, Bajaj, Reliance, Murugappa, Mahindra & Mahindra, Godrej, Lalbhai, Piramal, etc. Tata, Birla, and Bajaj have now become household names. These companies account for nearly 15 percent of the Indian economy, and their products have penetrated the lives of consumers in every aspect of life. When the founders died, their empires were taken over by their sons. And when the sons died, the businesses were passed on to their sons. Now with the second and third generations at the helm, it is a whole new India with its economy in an increasingly deregulatory mode. The descendants of the blue-chip dynasties are faced with a huge challenge: Transforming their companies into competitive dynamos that will prosper in the new global economy. Competition from multinationals and Indian entrepreneurs alike is coming on strong. Now, this is reckoning time for these family-run businesses.

The genesis

Family-run businesses tend to start with an entrepreneur, and as long as he is the promoter and shareholder, it would be a family business. Historically, there are very few businesses that were started by a group of professionals. Entrepreneurs start a business and so in the early stage it would be family managed. The world of business would not survive without them. In fact, around the world, families are the repositories of entrepreneurship. It is families that take risks and nurture new companies; it is from such families that more entrepreneurs are found. Companies go through a three-stage

process; family managed then professionally managed and finally world-class management.

It may not be surprising to note that 40 percent of *Fortune* 500 companies are family-owned or controlled. The family business is the world's most common type of business organization. It is also the most complex, with unique strengths and weaknesses that stem from being family-owned and managed. For a majority of individuals, family and work are the two most significant things in their lives. Family businesses combine these two worlds and create a unique set of consequences, which have positive and negative effects. The most important advantage is that it often starts a very high level of commitment to work. Family businesses tend to emphasize on high quality, invest for the long-term and develop loyal relationships with employees and other key stakeholders.

Competition from multinationals and Indian entrepreneurs alike is coming on strong. Now, this is reckoning time for family-run businesses.

This can make them tough competitors. At the same time, family businesses also tend to focus on issues and tensions within the family. A heightened concern with control can limit their growth and opportunity.

Globally, around 65-80 percent business enterprises are family-owned and managed. In India, around 80 percent of the companies are family-owned. Many of these companies comprise of small, sole proprietorships, which may never grow or be passed on to the next generation. But it is also a fact that many of them are among the largest and most successful businesses in the world like Mars, Fiat and Microsoft. Family businesses in the US generate half the Gross Domestic Product (GDP) and



employ half the workforce. In India, family businesses account for over 70 percent of all businesses and contribute very significantly to the national GDP. In most countries much of the retail trade, small industry and all manner of services are in the hands of the family, from the corner store to the high-tech manufacturing sector.

According to a study done by the Kellogg School of US, almost 95 percent of all global business started as family businesses. Although businesses of this description contribute as much as 60-70 percent to global GDP, only four percent of family businesses continue to grow on a steady basis. Just three percent of family businesses survive till the third generation and similar figures apply to India as well.

Given their importance, it is of concern to find that only a few survive to the second generation, and fewer still survive to the third generation. However, describing the characteristics of the next generation, Professor John L Ward, Founder Chairman, Family Business Consulting Group Inc. and Clinical Professor, The Kellogg School, says, "the fact that they were more

educated made them more competent and consequently more global; 19-year-olds are making more wealth than what their parents did in 30 years, thanks to new technologies."

Consequent to the recent developments in global economies, the business scenario has changed radically. There is a shift from family-run business practices to more professional management styles, even though family businesses may continue to dominate the economy. The big challenge for family businesses is to adapt to the new competitive environment. The entry of professionally managed business has forced the family-run businesses globally to transform themselves into professionally managed business entities. More and more family-run businesses are inviting professionals to take care of their companies. Though the control over the business still vests with the families, operational and strategic aspects are now taken care by qualified professionals.

In an environment which is characterized by increasing global competition and rapid market changes, how are family-run businesses coping with these challenges? It depends, says Drew Mendoza, President, The Family Business Consulting Group International. He adds, "Yes, there are industries, which have undergone tremendous waves of consolidation, particularly in the more cash flush years of the later 1990s. However, there are plenty of cases in which family-run firms were able to defend their market share."

However, Ernest A Doud, Jr., Managing Partner in the California-based DoudHausnerVistar, (strategic family business advisor) says, "In some respects, yes they are. Family businesses who have enjoyed protected territories and niche markets are finding that the competition can come from sources outside the boundaries of the territories they have traditionally served. As I see it, these new competitive pressures can have a positive impact on family businesses. They can serve as a "wake-up call," forcing them to look carefully at their business strategies—some of which are time-worn and in need of updating. Family businesses that accept and meet the challenge can actually come through the process better off for

the experience. Family businesses that rest on their laurels and deny or avoid the challenge will be hurt. But it will be their own fault, not their competitor's fault."

The Indian scenario

The scenario is no different in India. With the economic liberalization process underway, more and more professionally managed multinational companies are entering India. Family-run businesses in India have become used to operating in a controlled economy. Suddenly the entry of global players is posing challenges not only in terms of management but also in terms of long-term viability. Lack of killer instinct and professional management of massive family-run businesses are proving to be major sources of uncompetitiveness. It is always seen that there is very little distance between the family and business in India. Indian companies need to distinguish between management and ownership. The biggest threat to the family-run business is from the consumer who now has unlimited choice with the entry of global players. Besides, they face the challenge of managing the transition.

Not all family businesses have successful generation members who are competent in all facets of management. "Outside" professionals can be used to fill those gaps. If the senior generation seeks to step down before the next generation is fully competent, non-family professionals can be used to fill the gap temporarily and to help train and mentor

members of the successor generation. Few family businesses like the Ambanis of Reliance Industries Ltd., the Mahindras of Mahindra & Mahindra Ltd. were able to face the challenges of transition. Others have already stumbled. Families like the Khataus, Mafatlals and Sarabhais, who once dominated textile

industry have rolled down the hill.

Truly, unless there is a degree of professionalism in their management the future for them appears to be dim. Taking a cue from the failures and threats, some companies like Wipro, and Ranbaxy Laboratories took the risk of transformation. They have developed a new model—professionally managed but family controlled—a perfect blend of professionalism and entrepreneurship.

"We rarely find a family firm in which non-family management continues beyond a single generation. I haven't seen it continue for more than 10 or 15 years."

*Drew Mendoza, President,
The Family Business Consulting
Group International, USA*

Wipro is a typical example. People didn't really think that they could make it in IT with IBM coming to India and HP walking all over the Indian market. Abbot Laboratories, the pharmaceutical company had a dynamic CEO from within the family. He transformed the company from being good to great by systematically bringing in the best talent at the board level and in his executive team. Reliance also took the decision to go for world-class, motivated by the fact that they wanted to be global in costs. There are some who decided they would develop their own brands and compete. Others like Piramal followed a different strategy of growing through acquisitions. Ranbaxy too decided to grow through improving its R&D and establishing businesses abroad. The South-based Murugappa Group, renowned, successful and now into its fourth generation, won the prestigious Family Business Award 2001 at IMD Luzzanne, Switzerland.

Conflict of interests – The growing threat

According to a study done by McKinsey recently, the next 10 years will see most family-owned businesses coming under threat because of conflict of interests among members of families. The study included 30 leading family-owned businesses in India. To survive in the competitive environment, they must introduce best practices and lay down clear rules on governance and leadership. The study makes a very interesting comment: "The family-owned businesses are giving lip-service rather than bringing in best practices and it reveals that these Indian firms are severely threatened." Besides, most of them had and still have the mindset of

Family businesses that rest on their laurels and deny or avoid the challenge will be hurt, but it will be their own fault, not their competitor's fault

FAMILY BUSINESSES

property owners, and not managers. Such businesses are moving towards third-generation ownership, the most critical phase. However, their counterparts in the West have been wiser in this regard and had introduced best practices before it was too late. The study pointed out that only seven percent of the fully family-owned businesses have survived beyond the third generation. It stresses the importance of establishing a clear and valid role for the family in a business and equal treatment of professionals and family members in remuneration.

The study also touched upon the issue of leadership. "Building leadership among family members and defining their roles within a family are the key to success. The family members who remain outside a business should not try to exert much influence. Anand Burman, Deputy Managing Director, Dabur India Ltd., says families should understand the difference between family-owned businesses and family-run businesses to strike a balance. He reiterated that family members might not be the most competent. In case family members are not equipped to handle a business, professionals should be recruited. Incidentally, Dabur is a family-owned firm whose ownership is now with the fifth generation of the Burman family. Commenting on the same lines, Arun Bharat Ram, Vice-Chairman, SRF Ltd. noted that disputes, jealousies and differences in style led to disintegration. In many family-owned businesses there are differences, mistrust, conflicts and tensions between family members on one side and non-family business executives on the other. Each set often has its own beliefs, prejudices, biases that come in the way of smooth running of the organization.

From family to professionally-run businesses

Globally, there is a growing tendency towards getting outside professionals to run many family-run businesses. Drew Mendez explains, "We typically refer to such managers as Key NFMs (Key Non-Family Managers). In North America as well as in Europe, such

managers may be put into the role of President or CEO when there is no family member capable of doing the job required. The effective transition to a non-family management structure while retaining family ownership and control of the stock can be complex, if it is to be done well. As explained in the book *More than Family, Non-Family Managers in the Family Business* (Family Enterprise Publishers, 2001, www.efamilybusiness.com), it is done best when the family understands and agrees upon the need for the non-family leadership. Also the manager will need to know precisely what the owners expect of her or him. We rarely find a family firm in which non-family management continues beyond a single generation. Frankly, I question that "Many" family firms are indeed turning to non-family managers to run their firms. Yes, it does happen, but not with anything I would call significant frequency; and, when it does occur, I haven't seen it continue for more than 10 or 15 years."

Given their size and importance in the economy, family businesses play a crucial role in the social and economic lives of communities. Clearly, in case of India, they have played a great role and Indian economy at this stage cannot afford to lose family businesses. Ernest A Doud, Jr. is also of the view that "Family businesses absolutely have a place in today's business environment. When they are capably lead and well managed, and when the owning family is clear about how to manage its relationship with the business, family businesses

become most potent competitive forces. For this reason good, strong family businesses will remain the backbone of any nation's economy." Yet many family businesses are destroyed by family conflicts and lack of planning. Research shows only one-third of family businesses survive into the second generation and only 10 percent into the third. Now most of the Indian family businesses are entering into the third generation. Ernest A Doud, Jr., opines "Survival is always an issue for family businesses. The inevitable passage between generations simply brings new forms of challenge to the forefront. To our experience, sell outs by family businesses most typically occur because

"Family businesses who have enjoyed protected territories and niche markets are finding that the competition can come from sources outside the boundaries of the territories they have traditionally served."

*Ernest A Doud,
Jr., Managing Partner,
DoudHausnerVistar,
California, USA*

they find they have not prepared for the transitions they face."

Outlook

With growing competition from professionally managed businesses, family businesses are left with no other option but to turn to professionals. In order to thrive and survive, these dynasties need to separate professional matters from family interests, focus on core businesses, and become more accountable to shareholders. The younger generation has inherited overstuffed, bureaucratic companies with little relation to each other. Often profits were not reinvested in new plants or products, but ended up in family coffers. Most of them own minority stakes in their companies, on an average about 26 percent. With shareholders demanding more rights and foreign institutions demanding greater accountability, the families find themselves under pressure to perform more. However, most of India's dynasties are now trying to borrow the best practices from foreign companies. The Ambani brothers of Reliance Industries are an example of how to use liberalization to become globally competitive.

As India moves toward free market and integrates into the global economy, the only way to perpetuate a business dynasty is for family interest to coincide with shareholder interest. The entrepreneurs who understand this will be the success stories of new India. ■

N Janardhan Rao, Team Analyst

Reference # 1-2002-06-12

Global Auto Industry

The balancing act

The once buoyant auto industry is facing a severe downturn today. The slump in demand, overcapacity of many automakers, and saturation of certain 'evergreen' markets has placed the very existence of many a player in jeopardy. Companies for their part are reacting with discounts, cheap financing, shutting down plants and undertaking ambitious restructuring programs. These moves might permanently alter the equations in the auto industry.

A good number of economists believe in the theory of a 30-year economic cycle that determines our material well-being. They can find a good ally in the global auto industry in confirmation of their hypothesis. Consider this: Every 30 years a massive increase in consolidation and restructuring occurred in this particular industry, lasting for a decade. In the initial years of the 20th century, General Motors epitomized the early consolidation of the industry. The 1930s and 1960s has seen deepened shakeout and merger, followed by the 1990s. This time around consolidation amongst the auto firms—car, truck, and bus—was accompanied by the consolidation of the suppliers as they attempted to meet the new demands and global aspirations of their customers.

Dilemma of overcapacity

The players in the auto industry have voiced their concerns over the slowdown the industry is experiencing as a direct result of the global economic downturn. To add to the woes, the September 11 incidents have created tremendous pressure on the top and bottom line of many auto companies as claimed by them. But this general viewpoint is not convincing. Says James Durance, Research Manager (Automotive) at World Markets Research Centre, UK, "The auto industry was quick to point to 9/11 terrorist attacks and subsequent slump in confidence as being one of the main reasons for the poor performance of many recent companies.

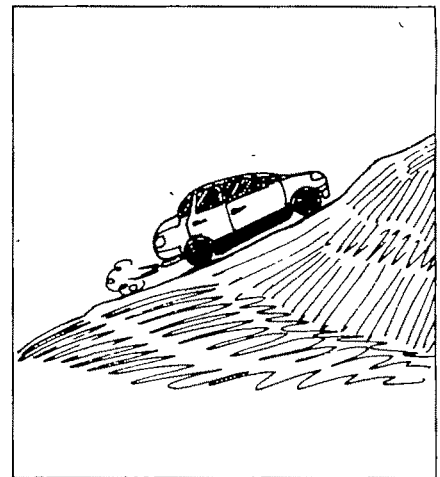
What that doesn't tell you is that most, if not all, OEMs (Original Equipment Manufacturers) and suppliers were already feeling vigorous pressures even before the global economy took a battering after the US terrorist attacks."

Every year the competition is intensifying and the industry has moved from a sellers market to a buyers market.

Specifically, North American car manufacturers are facing stiff competition from more cheap, fuel-efficient Asian cars. The weak yen and favorable foreign exchange rates have further dented the prospects of US carmakers as it enabled Toyota, Honda and Nissan to undercut them, other Asian rivals such as Hyundai of South Korea are adding to the capacity issue by opening new US plants.

This has aggravated the excess capacity created during the boom times, which now became the industry's main handicap. Now the utilization levels of the established production capacities are far below the potential. Take the example of Ford. Ford's problems start with its huge overcapacity in America. In the year 2001, it sold only 3.7 million cars and light trucks when it had capacity to produce 5.7 million. The problem is not limited to Ford alone. The current leader in terms of market share, General Motors (GM) operates at only 80 percent capacity. In fact, there is an excess capacity of 25 percent in North America and 30 percent in Western Europe, the two home bases of large auto companies. The resulting overcapacity is encouraging firms to sell extra cars at marginal prices in order to bring in cash.

The basic nature of the industry is cyclical and in many a market the demand has reached saturation point. This means that many markets have reached the peak in their demand curves and are definitely headed for troughs as observed by James Durance who says, "this has happened in many Western European markets recently, particularly Italy—and possibly the UK soon, which is defying gravity at the moment." This too has had a negative impact on the top and bottom lines of many carmakers. Fiat Auto declared an operating loss of €429 mn between January and March compared



with losses of €16 mn a year earlier as sales fell 11.2 percent year-on-year. The group made a net loss of €529 mn in the first quarter compared with a €193 mn profit a year earlier.

Deals, deals and deals!

There are a number of ways to overcome these problems. Professor DG Rhys, OBE, Director, Centre for Automotive Industry Research, Cardiff University Business School, UK observes, "Overcapacity can be overcome by joint ventures, mergers and takeovers, some companies leaving the auto industry, and closure of plants. In the short run, some plants can be mothballed or operated on fewer shifts. At the same time measures must be taken to reduce the break even point of operation." Some, if not all, of these solutions are being adapted by biggies in the auto industry.

Joint ventures and mergers and acquisitions marked the development of the sector specifically in the decade of 1990s. In a recent development, DaimlerChrysler AG (which itself was formed as a result of the merger of German automaker Daimler-Benz and

GLOBAL AUTO INDUSTRY

The Restructuring Bandwagon

The world's biggest auto majors Ford, General Motors and DaimlerChrysler AG have been undertaking major restructuring drives to counter the looming clouds of overcapacity and weak sales that are hovering on the sector. Restructuring has been a part of global auto industry.

DaimlerChrysler, in 2001, revealed an extensive restructuring plan to restore its financial health within two years. The main purpose of this exercise is to see its troubled US unit break even in 2002. Japanese carmaker Toyota has initiated a restructuring program code-named "Construction of Cost Competitiveness for the 21st Century" or "CCC21" with an aim to reduce costs by \$8 bn by 2005. General Motor's restructuring drive focused on gaining market share through a series of brutal price reductions on its products and cash incentives to its customers who purchased its products. These actions are fueled by zero credit finance offered to the customers.

Of all the auto companies, Ford has suffered the most due to the slack demand in the auto industry. Very recently it lost its market leadership to GM. The company cannot take the drastic step of closing down plants in America due to an agreement with the United Auto Workers that says any further closure of plants cannot be undertaken until 2003. Agrees Rhys, "Ford's turnaround plans are soundly based and realistic. The return to adequate profits will take some time. Attention is being paid to cost reductions and to revenue enhancements. The former will occur quickly but the latter will take time. Revenue enhancement will be based upon new models and the success of the Premier Automotive Group (PAG). In fact, by 2004/5, 30 percent of global profits will be generated by PAG. Therefore, recovery is based upon a widespread and well thought out and thorough strategy." The company announced plans of restructuring its business on January 11 this year. The main objective of the program is to improve the company's ability to produce high quality cars and trucks while maintaining an efficient cost structure. Some of the other proposals include a bid to reduce the North American plant manufacturing operating capacity by about one million units by mid-decade to realign capacity with market conditions. Further, a material cost-reduction program will be initiated with the North American suppliers that shares design savings, with Ford receiving 65 percent of realized cost reductions and suppliers receiving 35 percent in the first year. Through this program the company expects to improve ongoing annual profits before taxes by \$3 bn by mid-decade. The company is discontinuing low-margin models and is pursuing the sale of non-core assets and businesses. It expects a \$1 bn cash realization from these actions in the year 2002. On the financial side, the company is reducing the annual common stock and Class B stock dividend from 60 cents a share to 40 cents.

Compiled from DaimlerChrysler, Toyota and Ford Motor Company.

America's Chrysler Corp with the deal worth \$56 bn), Hyundai Motor Company, and Mitsubishi Motors Corporation announced a joint venture company, Global Engine Alliance LLC for the design, development, and engineering of gasoline engines. The advanced engines will be used in future generations of vehicles of the Chrysler Group, Mitsubishi Motors, and Hyundai Motor. The joint venture partners themselves are diverse in origin, competitiveness and product niches. The fact that they have joined together rather than competing with each other proves the daunting challenges faced by the industry.

Consolidation of the industry has in many cases bailed out companies that are suffering due to recession in the auto industry. The Italian carmaker, Fiat, and GM have a similar story to tell. Fiat announced an injection of \$1.6 bn into its battered car division Fiat Auto, which made losses of €549 mn in the year 2001. Fiat has a stake of 80 percent in the Auto division while GM owns 20 percent. The

parent company has an option to sell Fiat Auto to GM after 2004. Fiat Auto has been in shambles for years, suffering from an over-ambitious global plan, ageing products, and the parent company entering into manufacturing agricultural and construction machines and venturing into insurance and utilities market. The company is in major troubles after car markets in Brazil, Poland and Turkey collapsed where it had big operations. The company's domestic market is also witnessing a consistent fall in prices. Moreover, the company's European factories are working at only 75 percent capacity at a time when they need to work at 80 percent capacity to make profits. The company if it continues to under perform may be left with no other option other than selling itself to GM.

An impressive deal in the auto industry's recent past is the acquisition of the bankrupt South Korean auto major, Daewoo Motors by GM. The acquisition has generated considerable interest in the industry. Through this acquisition GM plans to reach previously ignored regions

like Asia, thus expanding its market share to one of the world's developing markets. James Durand also believes that, "Although conditions are set to improve in months and years to come, the pressure on margins will remain intense, and the 'right kind' of consolidation will be key to many players' prospects in the future." He further points out that "Renault and Nissan have shown how a successful alliance can be, with two very culturally distinct companies helping each other through their respective rough rides with aplomb. PSA and Toyota's new manufacturing plant in the Czech Republic is also an alliance with significant potential."

While consolidation is the move that is largely anticipated by industry pundits, there are some hiccups here too. In mega mergers the choice of the merger partners could make or mar the future of merged entities. In addition the time spent in integration would shift the focus of the company from external environment to the internal problems to

an extent that it leaves the company far behind in comparison with others in the industry. For some time DaimlerChrysler seemed to be a classic case of mega failure, however the aggressive turnaround is pushing the company away from failure. After spending more than two years in streamlining operations it is only now that the company is focusing on cost-cutting measures and is also taking a fresh look at product profiles. Durance emphasizes, "There are many examples of failed and failing alliances out there, however, and choosing the correct partner will be the all-important decision" Volkswagen for example, suffered huge cash outflows from its acquisition of SEAT, a Spanish carmaker. The company is struggling to cope up with the situation and is in the process of introducing new products that can fill the gaps existing in its product range.

In addition to combining forces, companies are dealing with this overcapacity by closing down many plants and laying off workers. Ford has initiated plans to close down five plants and reduce 35,000 of the global workforce. DaimlerChrysler AG, intends to shut six plants by 2003 and has axed more than 26,000 workers to save money. Isuzu Motors Ltd., a Japanese truck maker in which General Motors Corp has a strategic stake, is also planning to slash a third of its 37,000 workers by March 2004. In fact, automakers and their suppliers are in the process of shedding more than a million jobs, which is as much as a tenth of the total workforce in the industry.

Survival of the 'cheapest'

In order to dispose of their excess inventories and to push the demand, manufacturers are resorting to brutal price wars, undercutting each other and trimming profit margins. In addition to highly competitive price reductions, companies banked on cheap credit and costly marketing to prop up sales. General Motors was consistently involved in cost-cutting measures for the bulk of the past two decades and was prepared for a "price-driven" market. As a result the company claimed its first full-year market-share gain in three decades and was the only company that made profit in 2001 among the big three car

companies in US (GM, Ford and DaimlerChrysler). Ford, in contrast, is struggling with higher manufacturing costs and a heavy exposure to low-margin fleet sales.

Says Rhys, "Marketing measures such as price reductions, cheap credit, discounts etc., to increase sales have reduced profits per unit. In some instances this has reduced profits in aggregate or produced losses." Durance has a similar opinion. According to him, "companies are losing over US\$ 2,000 on each model when they are offering zero percent finance. In turn this is passed on to the component suppliers and other players, which is creating pressure throughout the industry." The repercussions of this kind of fierce competition and the myopic strategies of

the manufacturers to survive are frightening. Many manufacturers will be weakened and there is a possibility of few going out of business.

Emerging trends

The future will see companies in this sector adopting better design strategies and superior technology in making cars and a gradual shift to subcontracting major chunk of manufacturing process. Outsourcing in the auto industry is becoming a norm in the Chinese auto industry where carmakers are increasingly outsourcing manufacturing. *McKinsey Quarterly* cites the example of GM-Toyota joint venture NUMMI (New United Motor Manufacturing Incorporated). Joint-venture facilities can offer their manufacturing capacity to other brands—a strategy that has been used successfully at the GM and Toyota joint venture NUMMI in California, though these two companies do compete.

Rhys forecasts, "The motor industry will continue to adapt to changing circumstances. Problems emanating from congestion, noise, accidents, and emissions will see automakers having to meet more stringent social demands. This will not only be in the developed world but will embrace automakers in some of the "newer" production centers." Both the assemblers and the suppliers need to be more co-operative with each other. Ten years ago, auto manufacturers in Detroit, US, turned aggressive on their suppliers by seeking heavy price cuts in

order to recover from heavy losses. "Beating the suppliers over their head" became the mantra for these auto companies. In the changed scenario, companies cannot afford to do that. The major task for these companies is to fine-tune their relations with suppliers in a manner similar to how Japanese automakers deal with their suppliers. Companies like Toyota, Nissan and Honda maintain an excellent rapport with their suppliers and are reaping great cost savings.

The car industry, a part of the auto sector has been experiencing novel changes. The industry has not only become efficient, but also the manufacturing structure has undergone a sea change from the one created by Henry Ford. The entire industry is disintegrating as most of the production process is being outsourced. In future, it is possible that car companies will manufacture customer-specific vehicles, for delivery within, say, two to three weeks. This is not a new phenomenon in totality. This kind of "Build-To-Order" (BTO) strategy has been in usage for premium brands such as BMW, which is now catching the eye of volume carmakers. GM has initiated measures for a shakeout of its manufacturing processes and is gearing to graduate to the next level of BTO process. Consolidation of the suppliers and dealers in future will bring about astonishing changes in the structure of the industry.

Automakers should concentrate more on markets in the developing nations and instead of setting up manufacturing facilities they can take the route of cheap imports of factory seconds to gain market share at lightening speed. Emerging markets like China and India provide an excellent opportunity for many of these MNCs to survive. According to a report by World Markets Research Centre, UK, vehicle ownership in China and India is bound to rise significantly in years to come. With respect to India, International Players like Hyundai, Daewoo, GM and Ford have entered the market with some tasting early success. The future is not bleak for this sector. As more and more automakers realize the importance of making strategic partnerships and mergers with other industry players, the sector will consolidate and definitely see a revival in its fortunes. ■

Shashidar Mishra, Team Analyst

Reference # 1-2002-06-13

Russia vs. OPEC

Storm in the oilfield

Russia appears to be a 1st set and determined to rule the oil markets again. The rising giant is giving the cartel of Organization of Petroleum Exporting Countries (OPEC) tough competition and anxious moments. The battle between the two and the ensuing drama surrounding it—with all the economics, commerce, geopolitics, diplomacy that engulf a wealth like oil—will have great ramifications in the world economy and political scene.

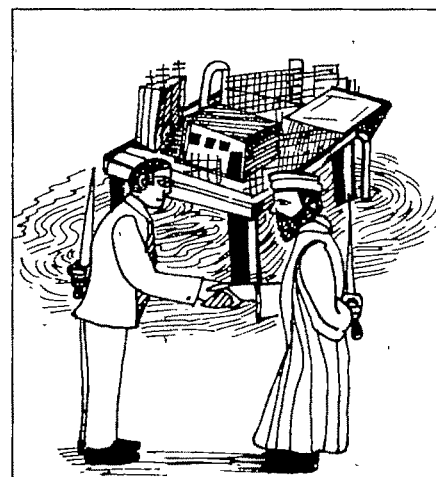
When Russia agreed with OPEC to cut its oil exports by 1,50,000 barrels-a-day (b/d) last December, nobody including itself believed that it would seriously abide by the promise. The decision to curtail production in the first quarter of 2002 was a gesture of moral support and was an easy one because the coming winter meant that production would anyway fall. In exchange OPEC members pledged to trim their collective production by 1.5 million barrels a day and to lower their exports by 462,500 b/d starting January 2002. Under pressure from OPEC, Norway and Mexico also agreed to cut 200,000 b/d and 100,000 b/d respectively. These cuts were made to sustain prices in the target range of \$22 to \$28 per barrel.

The Russians found ways to circumvent the promise with the Russian Government happily looking away. The export reduction pertains to oil that is supplied through pipelines outside the former Soviet Union so the Russians increased shipments through ports and rail, thereby actually raising total exports.

The Russian Government's decision to reduce export tariff on fuel oil under new customs rules and to completely lift its quotas on fuel oil exports fueled more exports. Moreover, Russian companies diverted crude oil that could not be exported to domestic refineries and refineries in Belarussia and Ukraine and exports of refined products to western and Central Europe increased. Russia's oil output in 2001 increased by 500,000 barrels a day. According to Petroleum Argus, a reputed British information agency providing information on oil and gas markets, exports outside the former Soviet Union grew seven percent last year. For 2002 as a whole, Russia's net oil exports are projected to increase to 5.01 million b/d.

In March this year OPEC and Russia met again to discuss oil prices. The 11-member cartel stated that it would continue production at the current levels until June. Though Russia has formally agreed with OPEC to comply with the export reductions in the second quarter of 2002 also, it said that it would reconsider

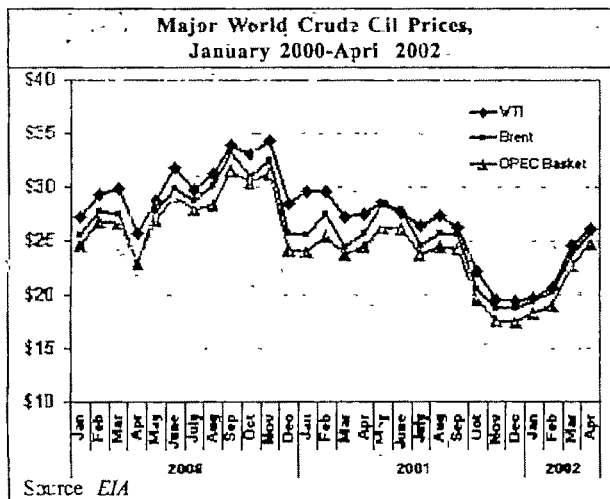
its decision if prices stabilize. The level of oil prices has been satisfactory and better than what OPEC could ask for. Crude prices have risen 32 percent this year because of political instability in Middle East, disruption of supply from Venezuela. An embargo by Iraq in protest against Israel's occupation of Palestinian territories augmented prices. Of course Iraq's decision to lift the embargo and resume exports on May 5 caused



oil prices to drop by two percent but crude price continues to comfortably hover around \$25-26 a barrel.

The rising giant

The rising clout of non-OPEC members, especially Russia is a cause for worry to OPEC but comfort to others. The once powerful cartel is finding itself dwarfed by new players with its share in world oil supply steadily decreasing over the years. The cartel's members are—Saudi Arabia, Iraq, UAE, Kuwait, Qatar, Iran, Venezuela, Nigeria, Libya, Algeria and Indonesia. The major non-OPEC oil producers are Russia, Mexico, Norway, Oman, Angola and Canada. While OPEC still controls more than half of the world's crude oil exports, just three of its members are among world's top 10 oil producers. The Gulf States, the major members of the cartel saw their share fall from 38 percent to 30 percent. Saudi Arabia still remains the world's leading crude producer, a position which was temporarily replaced by Russia in February; Russia officially became the world's biggest oil producer with seven million barrels a day—edging out Saudi



Arabia at 6.9 million. Russian oil companies expect their output of oil to grow 14 percent to eight million barrels a day by 2005. This means that OPEC's power to dictate prices is very much diminished because it no longer has monopoly over production or supply. No wonder OPEC is trying to get the non-OPEC members to co-operate in its endeavors to maintain price levels:

Russia is rising like a phoenix to recapture and become the world's number one producer as it was in the 1980s. Much of the oil that Russia possesses (it has 5-10 percent of the globe's proved oil reserves) was sold through long-term contracts during the Soviet era, so Russia could not affect the world's oil prices then. But the situation has changed today. The chaotic early years after the fall of Soviet Union, when production fell by 50 percent because of corruption and mismanagement have passed. Russian oil companies are showing commendable vision, commitment and initiative. The Baltic pipeline capable of transporting 240,000 barrels per day to the West was inaugurated recently and plans to build more such pipelines are being prepared. Foreign companies are also showing a great interest in Russia: British Petroleum (BP) has raised its stake in Sidanco, which is an affiliate of Tyumen Oil or TNK. Only five years ago BP and TNK were in court fighting over an oilfield. Russian oil producers are conducting more exploration and teaming up with foreign oil producers to develop oilfields.

Unlike other countries, which have nationalized the oil industry, the Russian Government's control over companies is minimal and the Government appears to have no intention of increasing control.

Top World Oil Net Exporters, 2001*

Country	Net Exports (million barrels per day)
1 Saudi Arabia	7.38
2 Russia	4.76
3. Norway	3.22
4. Iran	2.74
5. Venezuela	2.60
6 United Arab Emirates	2.09
7. Nigeria	2.00
8 Iraq	2.00
9 Kuwait	1.80
10 Mexico	1.65
11 Libya	1.24
12 Algeria	1.24

*Table includes all countries with net exports exceeding 1 million barrels per day in 2001.
Source EIA

Indeed plans to sell-off a six percent stake in the largest oil company Lukoil are afoot.

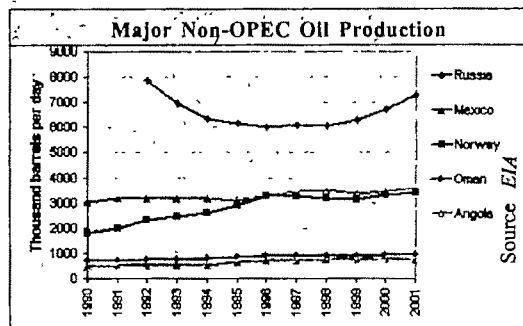
Oil companies are against restrictions on production and exports. The second largest oil producer in Russia, Yukos has opposed production cuts and has expressed plans to increase its output by 20 percent in 2002 and Sibneft, the fifth largest company, wants to raise production by 29 percent. The companies have invested heavily; the money came from the export revenues they earned in 1999 when oil prices were high and the exports grew because of the devaluation of the rouble.

The dwarfed cartel

The need to have a non-OPEC and non-gulf oil source has been acutely felt by the world. Afraid that access to the precious oil which is trapped in wells spread across the politically fragile Gulf nations might be denied to it at any moment, the west has encouraged the exploration and development of oil in other regions. US imports more oil from Mexico, Canada and Venezuela today. Mexico has replaced Saudi Arabia as the number one exporter to US. American imports from Persian Gulf were 23.5 percent of total oil imports in 2001 while they were 27.8 percent in 1977. According to US Department of Energy, 48.6 percent of US imports come from Western hemisphere today while the figure was just 34.5 percent in 1980. The search for oil is on in other regions. The cost of finding new oil reserves, which was as high as \$22 per barrel for US producers, is just around \$5 per barrel today.

But OPEC nations still have an advantage because they have cheap oil. It takes just around \$1 a barrel to extract oil in Saudi Arabia while it costs \$6 to \$8 a barrel to get oil in the Gulf of Mexico or the North Sea. If the oil prices would fall to low levels the OPEC countries would only see a reduction in revenues, but for Russia it would mean considerable losses, as costs of production are higher—around \$12 per barrel in some areas. Russia is, therefore, delicately placed. Since oil exports are the most important source of Russia's earnings, if it restricts exports it loses revenues but if oil price level falls, as OPEC says it would if production is not restricted, then again it stands to lose.

Even if it does cut production it cannot trust OPEC to do the same. Production quotas fixed by OPEC for members are not completely followed. OPEC



production data show compliance to cuts in September 2001 was running below 70 percent, the average compliance level for the cartel. In fact, even OPEC's decision to cut production by 1.5 million barrels per day was actually not heeded by the members and in March OPEC reported that members exceeded their production quotas by 779,000 b/d in February. To keep prices high they have undercut their market share and have generated idle capacity. The world political scene that has fueled oil prices has come to OPEC's rescue.

The compromise

The future for OPEC as the king in the oil industry at least in dictating prices is not as assured today as it was in the past. The Arab nations no longer want to rely on oil for their income and have turned to banking, shipping, etc. For example, crude exports contribution in Saudi Arabia's economy plummeted from around 70 percent in 1970s to 35 percent today. But OPEC will continue to be the world's leading source of oil simply because its members have vast reserves of cheap oil. Meanwhile Russia's oil industry is predicted to grow. Russia's future level of oil exports will be determined by its ability to produce cheap oil, which will require development of new deposits and massive infrastructure investment especially in new export pipelines. However, the development of alternatives to oil can see the power of oil economies including Russia diminish. But for now oil is on the agenda of both as the world watches the rivalry lurking behind the courtship for co-operation and the marriage of convenience. ■

Related Articles:

- 1 OPEC vs Russia—Dismantling APM: Progress and Prospects, *Analyst*, January 2002.
- 2 OPEC. Micromanagement of prices, *Analyst*, September 2001
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T Aparna, Team Analyst

Reference # 1-2002-06-14

Dabur India Ltd.

Building on brands

Dabur's core competence lies in its ability to conceive, develop and market products based on herbs and natural resources. However, with growing competition from Zandu, Baidyanath and Himalaya Drugs, Dabur's monopoly in ayurvedic products is under pressure.

The Rs. 1166 crore, Dabur India Ltd. (DIL) was established in 1884 and is one of the largest Indian FMCG company dealing with ayurvedic products with interests in healthcare, personal care and foods. For more than a century Dabur has worked in active collaboration with nature to provide the best of herbal health and personal care products to its consumers. Today, Dabur is all set to take its abundant knowledge of Ayurveda to global frontiers. It operates in the niche natural/ayurvedic products segment with a product folio of over 500 products. To its credit, Dabur employs more than 5000 people located throughout the globe and has 11 manufacturing units in India, Nepal and Egypt. The company has overseas sales and marketing offices in Dubai, London, New York and Moscow. Its distribution network comprises 21 sales offices, 5500 distributors and over 13 million retailers. Dabur Research Foundation is an independent research organization with more than 125 scientists at its service.

Dabur is a closely held company with the Burman family holding around 80 percent of the equity. Most of its ayurvedic/OTC (Over-The-Counter) brands are the market leaders in their respective segments. Dabur has developed considerable expertise in these traditional areas and has well understood the consumer preferences for traditional ayurvedic remedial measures.

The group comprises of Dabur Finance, Dabur Nepal Pvt. Ltd., Dabur Egypt Ltd., Dabur Overseas Ltd., and Dabur International Ltd. Product groups include healthcare, food products, natural gums and allied chemicals, pharma, and veterinary products. Its leading

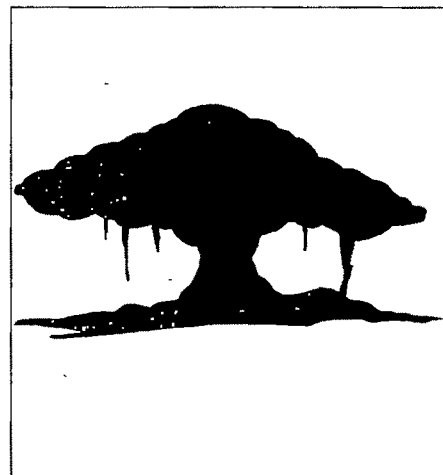
household brands include Dabur Amla, Dabur Chyawanaprash, Vatika, Hajmola, Lal Dant Manjan, Pudín Hara and the Real range of fruit juices. New product launches include Binaca toothbrushes, Imli candy under the Hajmola brand. The fruit juice brand was relaunched with new packaging; and the Hommade cooking paste range was expanded. Dabur's core competence lies in its ability to conceive, develop and market products based on herbs and natural resources. The top five brands contribute about 55 percent to revenues, amounting about Rs. 650 crore.

However, the year 2001-02 was not encouraging for the FMCG sector as the economy was in doldrums with the sinking demand and massive job cuts. DIL too had to face the reality. Dabur's growth rate of about seven percent is slightly lower than the industry growth rate. Against this backdrop, VC Burman, Chairman, DIL observes, "We would do better than the segment as we are improving operational efficiencies at all stages of the supply chain. The FMCG segment is growing at 2.5 percent and Dabur expects to grow by five percent by March 2003."

To withstand the competition, Dabur has started focusing on its core competencies and it has set in motion a slew of initiatives to ramp up its top-line and bottom line

Restructuring moves

Despite its range, investors have been wary of investing in this company because of its unrelated diversifications and a family-run business. To counter this, Dabur undertook a massive restructuring exercise about a couple of years ago, based on McKinsey recommendations to meet the growing competition and to focus only on core competencies and to gear up as the leading FMCG player in the country.



As a result, it decided to spin off non-core businesses and induct an all-new professional management team. Other positive actions include rejuvenating the sales and distribution set up, laying greater focus on brand extensions rather than on new brand creation and adding value to products.

It has discontinued its low margin businesses like merchant exports, generic drugs and herbal intermediates. The company has also exited from two JVs namely confectionery JV with General DE Confitaria India Limited and biscuits JV, Excelsia Foods Limited. The company has also hived off its foods business into a separate subsidiary, Dabur Foods Limited. During FY00 the company exited from Ayurved Herbal Veterinary drugs. It sold off its entire stake in Excelsia JV foods with Nestlé for manufacturing biscuits for a nominal value of Rs. 10. Dabur is also consolidating and rationalizing its brand portfolio. It has discontinued the number of small and marginal brands in personal care and healthcare products. It also decided to wind up its finance businesses. Though the company exited from beauty products business, with increasing

market size and higher margins the company has revived its interests in re-entering the business. In FY99, DIL has started implementing a Baan Enterprise Resource Planning (ERP) to cut the cost of inventory, which is a major component of its overall costs. Because of its high inventory levels, it has to bear high holding costs. It seems that all these initiatives are being paid off, and the analysts are optimistic about the current year.

Dabur has also restructured its board. Due to this, six directors, namely AC Burman, Sidharth Burman, Air Chief Marshal NC Suri (Retd.), SM Datta, Raja Vijay Karan, and Ashok Goenka have resigned from the directorship of the company and the board has accepted the same with effect from April 1, 2002. Further, VC Burman and Pradip Burman have also resigned from the whole-time directorship of the company, which has also been accepted by the board; however, they will continue as non-executive directors of the company. The company has completed its restructuring process and has exited non-core businesses. With the homespun philosophy that drives Dabur, it is now gearing up to face the challenge to an MNC onslaught.

On the financial front, the company's sluggish top-line growth continues to be a concern. It had posted a net profit of Rs. 22.33 crore for the quarter ended December 31, 2001 as compared to Rs. 21.93 crore for the same period of the previous year. While it has recorded a 1.3 percent rise in turnover at Rs. 319.8 crore during the same period, as compared to Rs. 315.7 crore of the previous year. DIL is exporting its products to Germany, America and other countries. Brands like Chyawanaprash, shampoo and even Real's mango juice are being sold in Canada and America. Exports account for 10 percent of sales and will be a thrust area next year.

ORG figures put Dabur's pharmaceuticals division as the second largest growing pharmaceutical company in India with a secondary sales growth of 37.2 percent and a mind-boggling 29 New Chemical Entities (NCEs) in pipeline. Analysts say, its pharma division is full of potential. In oncology segment, it is No. 1 in India. It is

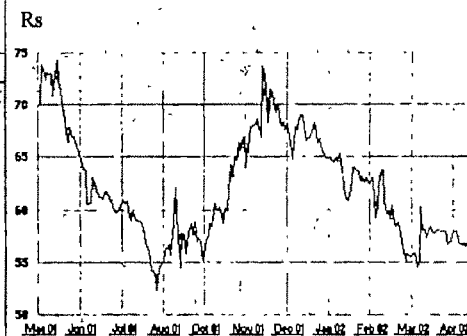
Inter-firm Comparison

(Rs. in mn)

	DIL 12/31/01	Zandu Pharma 12/31/01
Turnover	3,215	382
Total Income	11,841	1,055
PBT	852	67
PAT	779	61
EPS (Rs)	2.7	152.5
Net Oper. Margin (%)	6.7	8.2
Current Ratio	2.5	1.8
D/E Ratio	0.3	0.3
Return on Equity (%)	22	19.4

Source: Equitymaster

Share Price Movement



working in close co-operation with DRDO, CSIR and top universities in R&D. It is the first company in India to have developed the anti-cancer intermediary DAB-10 and its associated drug paclitaxel (Taxol).

Venturing into insurance

DIL recently decided to venture into the insurance sector in a tie-up with Allstate. The venture is called Dabur CGU Life Insurance Company and is expected to start with an initial capital of Rs. 110 crore. Dabur CGU life, is a 74:26 venture between Dabur and UK-based CGU, which manages assets worth over £200 bn worldwide and is among the leading players in pension sector in UK, France, Ireland, Poland, Netherlands and Turkey.

The insurance venture proposes to begin its operations with an offer of

three life insurance products. The profiles of these products have been submitted to the Insurance Regulatory and Development Authority (IRDA) for approval. One of these is a single premium product. The other two, a regular premium product and a savings and protection product, would be launched with a feature that is as yet unique in India—they will be indexed to inflation by default.

Future Plans

DIL wants to focus on developing the healthcare, personal care, oncology and foods businesses. It is upgrading facilities at different plants to achieve faster production and introduce better

packaging. DIL has plans to launch an entire range of ayurvedic products in the domestic market soon. It is looking at launching approximately 10 to 20 new products by next year. The thrust would be on positioning the drugs as prescription products rather than OTC drugs. The company is also focusing on exports of ayurvedic products into new markets this year including South Africa, Russia and Malaysia. Further, Dabur Research Foundation (DRF) has reached a Memorandum of Understanding with the Central Council of Research in Ayurveda and Siddha (CCRAS), a council under the Ministry of Health and Family Welfare, for the development of a new drug. The agreement is aimed at undertaking further upstream R&D work in respect of ginger-based formulations developed by CCRAS for the treatment of rheumatoid arthritis. DRF will undertake upstream research work on the products of Sunthi-Guggulu and Sunthi-Guduchi, which would include development of a more consumer-friendly dosage form, scaling up the production process for the same, unit dose regulation and further clinical research.

There is no doubt that Dabur has one of the better valuations in the FMCG spectrum. However, with growing competition from Zandu, Baidyanath and Himalaya Drugs, Dabur's monopoly in ayurvedic products is under pressure. Besides, with HLL considering a foray into this segment, Dabur has to gear up its act further. Dabur is presently trading at Rs.55 (May 20, 2002) on the BSE at a P/E of 20.37. ■

N Janardhan Rao, Team Analyst

Reference # 1-2002-06-15

BOOK SUMMARY

Trading in the Zone

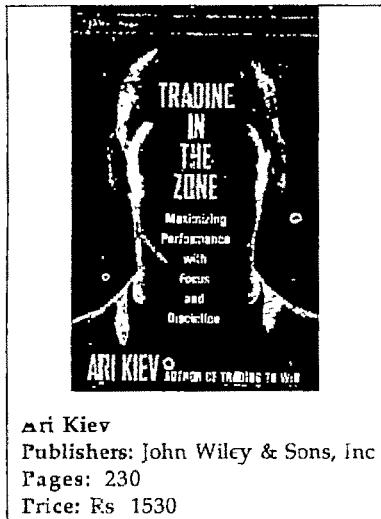
Maximizing Performance with Focus and Discipline

Though most people aspire to trade in financial markets, they always tend to fall short. At a time when the markets are fast changing, it requires a lot of effort to remain focused while entering the trading zone. The power of trading in the zone improves the success rates of traders in an unusual way.

Trading is a complicated process due to the incredible volatility and unpredictability of the market and the roller-coaster ups and downs that are experienced daily by the traders. Many a times, there are emotional waves activated among the traders by these wide swings of success and failures. In the process, traders get into psychological issues like resistance, fear of failure, defensive behavior, negative self-characterizations and a negative mindset that become self-fulfilling prophecies. This is more often seen in case of traders who actively participate in securities trading irrespective of whether they are experienced or inexperienced.

To be successful traders must recognize the repetitive patterns in their behavior and situations where there are

opportunities to extend themselves. Once a trader is out of the negative mindset, he will be in a better position to enter the winning zone. Successful traders continually gauge the market and contain the natural distortions that interfere with their capacity to see the reality of the market. For trading in the winning zone, traders need to learn the application of intelligence, communication skills, reading and taking note of the activities.



Getting in the zone

For entering the zone, one must understand the zone in the right sense. The zone is an ideal psychological state where everything is done correctly. Entering into the zone indicates that one is trying to get into a centered state of mind and activating positive memories of the past positive experiences. This allows the traders to trade in a disciplined way and stay close to opportunities. Being in the zone, traders can overcome inertia and perform more work with less effort. Once in the zone, traders get a sense of freedom, excitement, alertness and the ability to focus with clarity. Trading in the zone is not that impossible as much as staying in it. It requires work, which begins by learning a set of skills. It also requires depth, knowledge, ability to explain the activity and understanding the

business. The better skills one possesses, the better he can perform even on a bad day.

Most often players, who try to enter the zone, are those who think big. Although getting into the zone means different things to different traders, it is important to first enter the zone. It requires conviction and this comes from a willingness to trade the ideas and develop confidence in the ability to assess the crucial factors. Traders have to continuously trade to get into the zone. There should be a positive effort to move into the zone until the right trade is found. Once inside the zone, things move smoothly and in the desired direction. And being in the zone means staying on target. It means following the strategy and trusting the game plan. The capacity to trust the instinct and to go ahead with the flow is where one can experience the phenomena of trading in the zone.

However, the biggest problem is that of staying in the zone. It is a constant process, which requires correcting the course as and when needed. Traders have to look for new opportunities and distinguish them from the old ones. The key to staying in the zone is recognizing the point when one is falling and trying to get back onto the track. Another way of staying in the zone is to increase the target. One needs to start playing at a different level. As and when one realizes the target, he needs to set a higher target. Trading is about solving a mystery, a problem or piecing together a puzzle. This process is very absorbing and requires constant and intense focus; at the same time it makes trading very exciting.

Though human beings have an extraordinary ability to master the environment, they fail to master certain fundamental principles of life. Human brains lock into old habits, which, in turn, keeps them away from seeing the reality. Many a times, humans are held back by their own thinking and inclination to perceive the world through old perceptions. To trade consistently in the zone, it is essential to be aware of the underlying unconscious assumptions. Concepts from the past keep humans away from the present. The way a trader trades is a reflection of the life principles and the conscious and unconscious designs or the structure of thinking that is programmed in him since childhood. The trading patterns do not change much, although a trader tries to shift or change thoughts, until he is aware of the past assumptions. Recognizing the life principles enables a trader to determine how much these principles influence the perspectives and responses to events. It is very important to consider the extent to which the concepts limit one's ability to foresee things. The traders have to think about the obstacles in achieving the creative vision.

The solution to escaping the predicament of early programming is to live outside the limiting constraints of the intellect, habits and past perspectives. Consciously creating a

vision enables traders to do away with past habits so that they can tap the full potential. There are some common life principles that the traders tend to develop in the course of life. Some of them are averting losses, rejecting a win, denying reality and following the herd. Unless action is taken to change these behaviors or attitudes, traders will not be able to push themselves to a higher level of success.

To be successful in trading, traders should set specific goals and perform that amount of work, which is commensurate with the goals. The goal should be used as a lens through which trading decisions can be guided. One big step towards shedding constraints that lock into the past is to trade in terms of specific goals. It is possible to select powerful and meaningful personal goals as guiding posts to the actions. This will enable the traders to focus all their efforts on achieving results and tap all the untapped resources within them. Ideally it should be used to plan the strategy, measure the performance of what has changed and what needs to be added. It helps to determine the size of the trade to reach the target. It also helps in knowing when to exit from a trade and take the profits. Traders have to continuously examine their goals and adjust them accordingly. Most importantly, goals should be their reflection and self-control needs to be avoided. Trading strategies have to be developed to attain the set goals. Then a plan has to be developed to implement the strategy, measure it and review it.

What differentiates a superachiever from the average performer is that the super trader sets the goals and determines what must be done to achieve it. He does not allow his preconditioned beliefs and preconceptions to determine his actions; in doing so he is able to tap hidden creative energies. To be most successful, the trader must learn to remain confident in the face of repeated losses. He has to stay focused to achieve the goal and build on it for further success. As the trader changes his frame of reference, his response to the events changes. As a result, effective trading takes place and soon he will find himself trading in the zone more often.

Preparing for the trade

In the real world there is a disparity of information and perception between people which provides for inefficiencies in the marketplace. Information in trading is more crucial. The more a trader researches, the more likely he is able to develop his conclusions based on the interpretation of the data. A good trader will not ride the wave but anticipate the wave based on an understanding of the stock and the company's strategies and actions. With the help of the research, only traders can differentiate between the wide swings brought about by the fluctuating sentiment and the real value of the stock. On a higher level, traders need to develop interpretive skills to trade and expand beyond reactive trading. To be successful, traders should have some perspective that allows an early entry into the trade and a longer stay.

News today may not spurt the prices of the stock but it can be used to gain the knowledge to be beneficial in the future. The information gained by the trader should have some validity. Traders have to identify the right information and determine what is pertinent to them. The key is to determine what is relevant and real and what is not. In order to be efficient, a trader must have systematic ways of managing the information. This is useful to have knowledge of the markets and the trends. Effective management of information helps the trader in understanding who is trying to do what, why, how much and when? Delving deeper helps in knowing more about the

About the Author

Ari Kiev is a psychiatrist who specializes in stress management and performance enhancement. He is also the President of the Social Psychiatry Research Institute and is recognized worldwide for his pioneering work in transcultural psychiatry, suicidology and psychopharmacology. He earlier authored the book, *Trading to Win - The Psychology of Mastering the Markets*, which is highly acclaimed.

company, what to trade and where to add and when to exit. The more the trader works with the information, the more decisive he will be in decision-making. Perhaps the biggest challenge to the trader is to time the information in the context of other things he knows about the stock and its trading patterns. Successful trades can take place only when the trader has a unique perspective in comparison to the rest of the market. This can be achieved by proper information and good handling experience.

Today there is abundance of information in finance and economics. Traders can narrow it down by choosing sectors. Traders should allow their minds to skim the free flow of information and filter out the less important material. The small pieces of valuable information make the difference between a super trader and an average trader. For piecing the information, traders need specific tools like technical analysis and indicators by which they can search for and separate the vital information from the non-essential. Both micro and macro information variables should be understood and analyzed for successful trades. Any assessment of a company should be done in the larger context of state of the market. Of course, different people perceive things differently. Therefore, evaluating the market is comparable to solving a big puzzle. Markets keep changing. Successful traders solve the puzzle and earn a lot of money.

To solve the puzzle, the information available with the traders might not be sufficient always. A lot of information from a vast array of sources is required. Importantly, traders have to know the psychology that drives the market for a particular stock. Information is available to all and not just the successful ones. Successful traders constantly look out for more information and re-evaluate the fundamentals against the market movement of the stock and sector. All the information gathered must be used to make decisions in line with the strategy and to achieve the goals. It helps the trader in evaluating the company and learning more about it. The trader must have more than one source of information and more than one technique to evaluate the company. Only then, the trader will have an edge over the others and will be successful. Greater the understanding of the business model, the better it is. Equally important is the understanding of the unseen variables along with the fundamentals and information. To trade in the zone, traders must watch what the people are doing and how they are reacting. It can give a clue about what is happening in the market and what is likely to happen. A good trader focuses not only on numbers but also on the response that is given to the incremental information. This base of knowledge is necessary to begin the journey to the zone. This helps in reacting better even if things are changing fast. It is a passion and no doubt, it takes a lot of time to develop.

Controlling the risk

Trading is a risky business. Successful traders always measure risk and the probability of loss against the amount of profit they are seeking. Typically this is done by a complex, highly intuitive process of monitoring their emotions, controlling

TRADING IN THE ZONE

their losses and managing the capital in line with their performance. Based on their experience, they should know when to get in and when to move out of a deal. They ideally should look for a 3:1 risk/reward ratio. The downside risk must be less than the upside potential. Traders also have to decide on their exit points on the upside as well as the downside in advance. It is important to determine the range in which to trade and how much of capital to risk on trade. This is a disciplined and risk-managed trading.

One way to determine the capital allocation and the risk/reward ratio is to review the statistics. The use of trade level data has made it possible to review performance statistics that can be used to identify specific and measurable patterns of trading behavior. A review of trading statistics can be beneficial to both risk managers as well as the traders. This also helps the traders to be objective. This helps in determining the strengths and weaknesses patterns of trading behavior and indicates the limits and constraints of the traders. The behavioral and psychological dimensions of trading patterns reveal certain characteristics, which in turn help to focus attention on behavior that can be modified. This also helps the traders in increasing their trading acumen by taking more risk. The biggest obstacle to success is the reluctance to add when it is right. Traders must play big, if they want to succeed. When playing big, traders should look for stocks that are liquid, availability of catalysts and good risk/reward probabilities. Risk management is crucial for a trader to be in the zone as it cuts down the losses and allows him to take profits in winning trades. Traders have to manage their pain and maintain enough capital to continue trading in the long-term. It is equally important to build a long-term portfolio. While considering risk management, trader needs to consider the objectives, strategy and the risk parameters involved. Basic questions and parameters must be assessed and then adjusted according to the basic assumption of the asset class in which they are trading. Traders have to extensively know about the catalysts, the price action or supply and demand character of the stock. Risk management is an essential weapon in the arsenal of the trader and a vital link to trading in the zone.

Negative feelings, anxiety and discomfort sometimes go hand in hand with risk. They have to be mastered and overcome. The market exacerbates a range of emotions including fear, greed, pride, frustration and panic. Successful traders should judge their success by their adherence to their strategy in the face of wide and unpredictable movements in the market and not by their profits and losses. This indicates that traders need to be disciplined and manage their emotions in order to adhere to their strategy. Perhaps there is no fixed way to eliminate negative feelings. To trade in the zone, traders have to learn how to ignore those feelings. Traders have to measure their feelings and learn more about them. Traders have to handle the losses and need to have a positive set of mind despite the repetitive losses. Anxiety builds up with each new day of losses. To be successful, traders have to embrace losing as part of the trading process. Traders have to stay focused on what they can do to reduce the risk. It is the state of mind of the trader that determines his long-term success.

Trading consistently

Master traders aren't perfect always. Many of the mistakes made by traders stem from normal human responses to the uncertain and unpredictable conditions of trading. Sometimes, best traders also commit mistakes. Some of the common

Snapshot

- The book explains the importance of being in the zone and the ways to enter and stay in the zone for long time to become a successful trader.
- The author explains some of the personality traits that often hinder a trader from becoming a great trader and suggests the means to overcome these obstacles.
- The author comes out with a perspective that goal setting and adopting the right approach to achieve the goals helps the traders to improve their performance drastically.
- The book highlights the importance of information and its processing in making effective decisions.
- For traders to achieve their targets understanding the micro and macro analysis is imperative.
- For traders to obtain an edge over their competitors, it is important that they learn more about the company, its fundamentals and visualize the unseen variables.
- The importance of risk management in trading and some easy ways to achieve the desired results are discussed in the book.
- A failure in trading leads the traders into an emotional setback. The author suggests that controlling the emotions and handling losses effectively will lead to success.
- The book says that it is important for traders to learn from their past mistakes and identifies some of the common mistakes that traders commit in the process of trading.
- The book explains the importance of overcoming psychological obstacles.
- Advanced strategies like capitulation and short selling can be used effectively to achieve the desired results.

mistakes that traders commit include picking wrong tops or bottoms, holding on to losers, being too loyal to a particular company or stock, holding on to a stock out of a sense of egotism, keeping the stub ends and averaging down. Other mistakes that traders commit are failure to take profit, relying on intuition, bidding for stocks and overtrading. No doubt, each trading situation is unique and there is no rule that fits all. In reality, most of the traders make a combination of mistakes but not one.

Reviewing the mistakes helps the traders overcome at least a few of them. Setting a daily goal will help the trader use it as a lens to determine what a trader must do. A successful trader focuses on a large target which helps him to continually adapt to new procedures and methods designed to reach the target. Traders have to keep defining their targets and strategy to keep going; in the process they can pull more out of them. It is important that traders consider the facts. In every situation a trader must take note of how his emotions influence his actions. And in every situation, he needs to trade for a daily goal and follow a predetermined strategy. Learning from the mistakes is an effort to prevent repeating them. This forms the crucial part of trading in the zone.

No individual is born with the perfect personality for trading and everyone brings with him or her both good and bad traits. In fact, strength of a trader sometimes can become his weakness. Traders need to identify psychological obstacles that may result from their long-standing personality traits in order to structure their trading strategy independently of them. Unless the obstacles are cleared, the same old trading patterns will persist. Some of the common psychological obstacles that appear and influence the trading behaviors are, letting go of seller's remorse, perfectionism, the "poor me" syndrome, complacency and the inability to adjust to changing

market environment. Perhaps, psychological obstacles are the most difficult ones of all, since humans continuously battle with them. If a trader finds himself tapped repeatedly by the psychological obstacles and thoughts, he has to consider the secondary gains or benefits received by holding on to them. Though habits and beliefs have not been developed for secondary gains, by knowing how emotionally involved one is in his fixed perspective can help him break free those restrictive habits and become more experimentally engaged in trading.

For newcomers, trading appears to be deceptively simple. However, it is not so. Repeated success in trading involves a lot of elements like hard work, discipline and the flexibility to adapt to changing environment. Gaining mastery requires a willingness to commit to success since trading does not provide instant rewards. They have to be patient and focused. They have to overcome all the personal traits that serve as obstacles.

The experience of successful traders suggests a few lessons for the newcomers like staying focused, never abandoning the opinion, don't say "Burnt out" and don't withdraw in between. In order to stay in the zone, traders have to let objectives govern whatever they do. They have to reach today's potential and learn to expand potential through focus, research and trading techniques improvement. Similarly, newcomers should try to identify their own self-sabotaging patterns and work to get rid of them. While great traders are not always born, good traders can be made.

Using advanced strategies

To be successful, traders have to enhance and multiply their skills. Once in the zone, traders gain the momentum and grow.

By trading in the zone, traders can trade size, manage losses better, keep moving, process more information and act more decisively. Importantly, trading in the zone helps the traders to put into action the most advanced counterintuitive strategies. Once the trader masters the basic strategies of the trade, he can use the advanced strategies like capitulation and short selling to improve the success ratios. Capitulation is a result of emotional buying or selling that creates price extremes at either high or low levels. Since it can happen for a variety of reasons, understanding the concepts and the strategy clearly is important before it is being put into action. The ability to short stocks takes a higher level of conviction. It is not mastered by many. A short sell is a reverse of a long trade. To succeed in short selling, traders have to do many things that they do when in zone but at a higher degree. Shorting is a strategy that works best for those who are able to stay centered and trade in the zone.

There is a reality in the world that one cannot perceive because he is limited by what he believes he knows. If traders can let go of their preconceptions and life principles long enough to see what is in the world in terms of a larger creative vision, they will be able to explore new opportunities for trading in a powerful and stimulating way. Everyone has the power to change by committing to a larger vision and ignoring their automatic self-protective notions. Once they tap the hidden potential within themselves, they can live beyond the limits of ego, anxiety and habits. Reaching the specified goals will allow the traders to experience the exhilarating power of trading in the zone. ■

Y Chandra Sekhar, Team Analyst

Reference # 1-2002-06-16

VERBATIM

It's one of the hardest things to grasp, but the more successful a group is, the more you ought to split it up.

— John T Chambers, CEO, Cisco Systems, on the company's strategy of decentralization of power to have a better customer focus.

Instead of just looking at a company's financial statements, MFV (Managing For Value) looks outside the company to ask two important questions: What's the pool of the economic profit in a given marketplace, and how competitively advantaged or disadvantaged is a certain company's position within that pool?

— Jim McTaggart, Co-Chairman and Co-Founder, Marakon Associates, a US-based management consultancy, on the concept called Managing For Value.

The completion of the IPCL disinvestment by the Government of India will mark a new milestone in the government's PSU disinvestment program, and will carry forward the process of economic reforms in the country. We are happy that Reliance has had the opportunity to play a role, and to contribute substantial value, in this process.

— Anil D Ambani, Managing Director, Reliance Industries Ltd.

Asia will need some \$200 bn in the next 10-15 years to build enough gas and power infrastructure to underpin fast growing regional economies.

— Tatsuo Masuda, President, Asia Pacific Energy Research Center (an affiliate of the Institute of Energy Economics of Japan).

I would say that our growth in exports, particularly in the UK markets, will begin from this year with our plant being approved by UK MCA. We feel that this is going to be our growth driver for next year.

— Pankaj Patel, CMD, Zydus Cadila.

We are holding discussions with the largest software developer in India for designing software products for the international market. We have the domain knowledge while they (software company) have the market expertise.

— A Ramamurthy, Current-in-charge and Managing Director, LIC, on the company's international foray.

Strategy in the DRAM (Dynamic Random-Access Memory) business is simple, as is the business model. Also, the road map for future development is clear, so I think our joint venture will work out.

— Hajime Sasaki, Chairman of NEC, on the feasibility of the JV between NEC and archival Hitachi.

Opening of three new ICFAI Offices

We are happy to inform that ICFAI has opened offices at three more locations viz. Agra, Coimbatore and Noida with the objective of providing programs information, counseling, administrative and other services to the existing and prospective students of ICFAI. The students of these cities are welcome to contact the ICFAI Offices for clarifying queries and getting other services at the addresses mentioned below:

Agra	Coimbatore	Noida
ICFAI Office No. 10, First Floor Block No. G-13 A/B Sanjay Place Agra - 282002.	ICFAI Office "WHITES", 2nd Floor 550/8, D B Road R S Puram Coimbatore - 411002	ICFAI Office Flat No 414 4th Floor, J O P Plaza P - 2, Sector - 18 Noida

New Test Centers

With effect from July 2002, ICFAI examinations are proposed to be conducted in 50 cities. The addresses of Test Centers in 29 cities are given in Annexure IV of the ICFAI Candidates Regulations, 2002. The names of 21 additional cities where ICFAI examinations will be conducted are as follows:

City	Center Code	City	Center Code	City	Center Code
Agra	133	Jamshedpur	140	Nasik	147
Aligarh	134	Kothapur	141	Noida	148
Amritsar	135	Ludhiana	142	Ranchi	149
Fardabad	136	Madurai	143	Siliguri	150
Ghaziabad	137	Mangalore	144	Surat	151
Gwalior	138	Meerut	145	Udaipur	152
Jabalpur	139	Mysore	146	Varanasi	153

The addresses and other details of the Test Centers in the above cities will be informed to the candidates in due course through Website.

Annual Service Charges

Candidates of the DBF/PGDFA Program who are enrolled on or after April 01, 2000 may note that they are required to pay Annual Service Charges every year. The period of one year is reckoned from the date of enrollment.

With effect from April 01, 2002, the candidates are required to remit the Annual Service Charges before 1st of the month in which the service charges become due for payment. A late fee of Rs. 100 per month is charged in case of delay in remitting the Annual Service Charges.

All candidates who have enrolled in the DBF/PGDFA program on or after April 01, 2000 and not yet remitted the Annual Service Charges for the year 2001-2002 and/or 2002-2003 are required to remit the Annual Service Charges with a late fee of Rs. 100 per month. Annual Service Charges can be remitted using Form 110 of the ICFAI Candidates Regulations, 2002.

The candidates, who do not remit the Annual Service Charges, will be denied all the student services without further notice.

July 2002 Examinations

The next ICFAI Examinations are scheduled to be conducted from July 06, 2002 to July 28, 2002. The last dates for submission of the Examination Registration Form is as under:

ERF accepted from	May 06, 2002
Last dates for submission of ERF	Without late fee : June 08, 2002
	With late fee of Rs.100 : June 15, 2002
	Walk-In Registration : Date of Examination

Candidates intending to appear for July 2002 examinations are advised to submit the ERF before the last date mentioned above. Candidates are required to check their eligibility and ensure the following before submitting the ERF for July 2002 examinations:

- There are no fee dues.
- The Postdated Cheques issued to ICFAI towards course fee are duly honored.
- Confirmation of enrollment by ICFAI after receipt of duly filled-in Evaluation Forms from the references.

Candidates who have already applied for July 2002 examinations are requested to note that the Admit Cards for the eligible candidates have already been placed on the website www.icfai.org for download. The Admit Cards are also being mailed by post to the eligible candidates.

Candidates may also note that with effect from April 2002 examinations, each Admit Card is given a separate Number. Admit Card Number is different from Enrollment Number. All candidates are required to mention their Admit Card number and also their Enrollment Number on the Answer Sheet.

MOST IMPORTANT NOTE

Evaluation Forms from the References

With effect from April 2001, candidates who enroll in the DBF/PGDFA Program are required to furnish the addresses of two references in the application form for enrollment. Evaluation Forms are sent to these references by ICFAI for an assessment of the candidates seeking enrollment into the Program. The enrollment of the candidates into the program is provisional till the Evaluation Forms are received from the references with no negative remarks. In this regard candidates may note that they are required to follow up with their references, if their references have not sent the filled-in Evaluation Form back to ICFAI. Reminders have been sent to all the students whose references have not forwarded the Evaluation Forms within 30 days from the date of their enrolments. **Candidates will not be allowed to appear for the examinations till the Evaluation Forms are received from both the references.**

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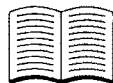
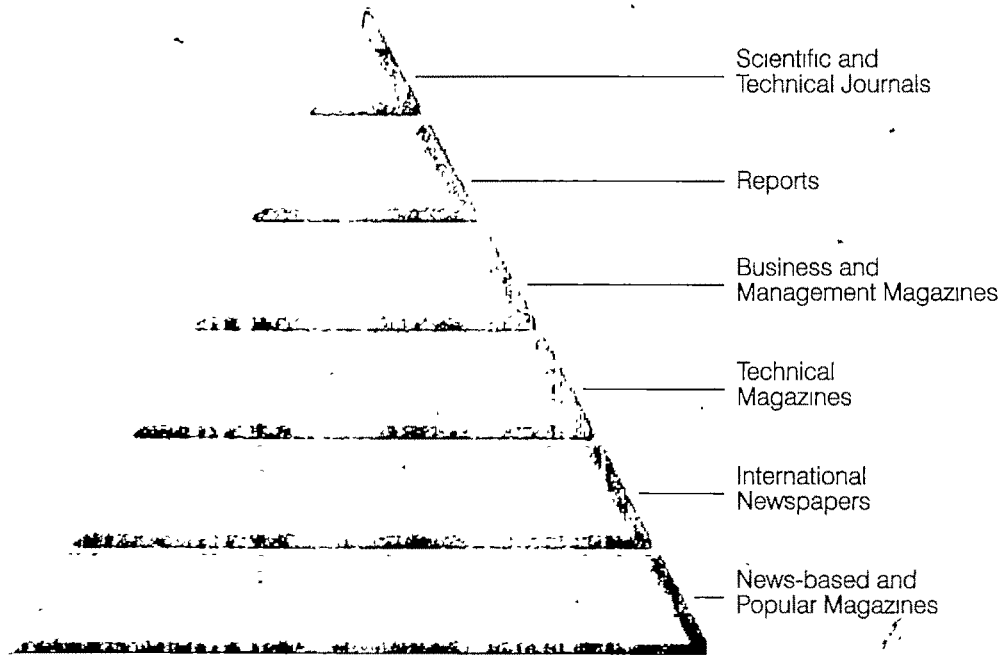


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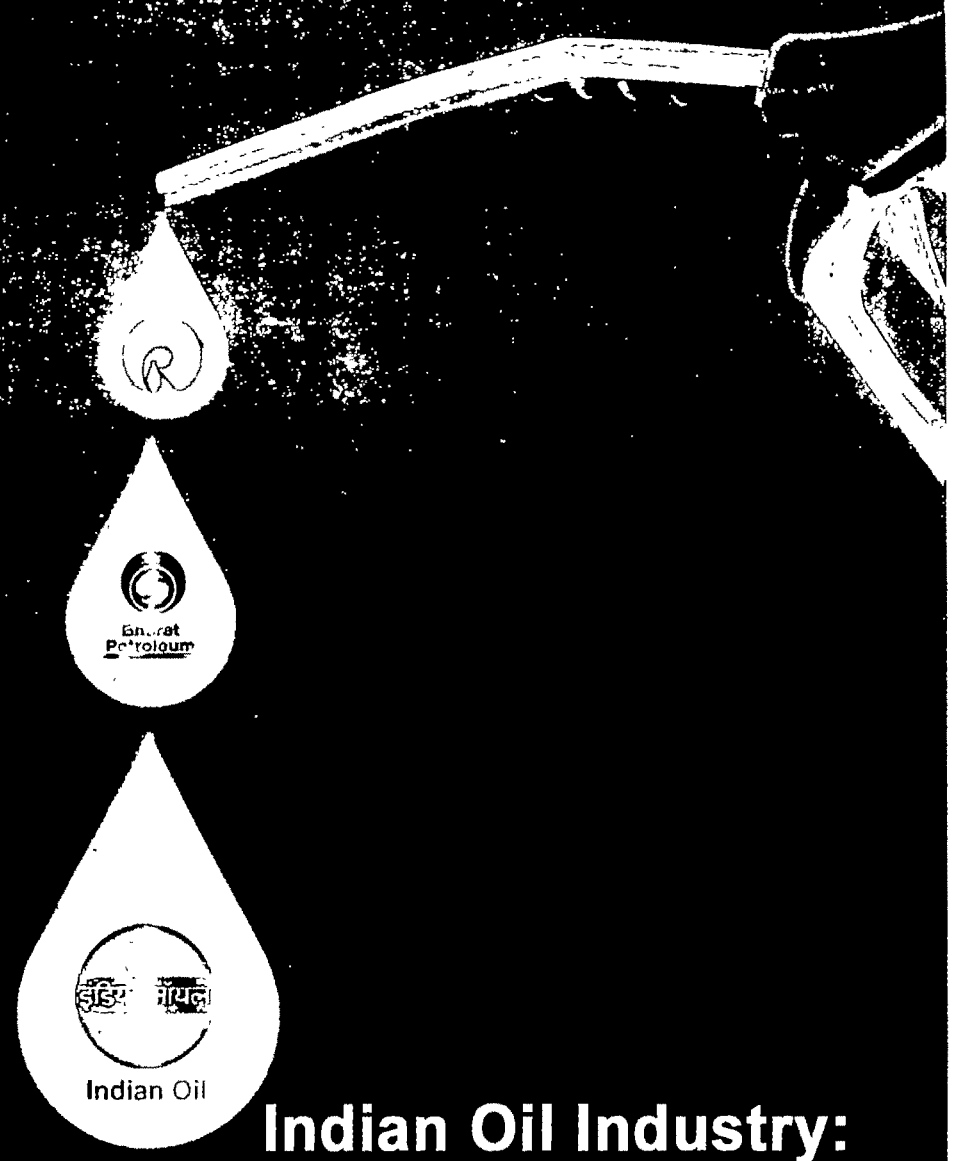
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July 2002

The New Age Finance Magazine

Rs. 50



Indian Oil Industry: The Emerging Order

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Editor EN Murthy

FOCUS

Slick Reforms

Having realized willy-nilly that it has no business to be in business a decade ago, the government has initiated reform in the oil sector at the usual snail's pace. Perhaps compelling vote bank concerns prevailed over the interests of the reform process. The APM or the Administered Price Mechanism continued the legacy of subsidy distorting the true cost of not only the oil products but also many other commodities whose prices got determined by the oil prices.

The oil sector reforms got a shot in the arm with the dismantling of the APM from April this year. The sector is agog on account of the foray by new entrants like Reliance etc. Yet the government's attempts to retain control through Indian Oil Corporation make a mockery of the spirit of disinvestment. Moreover the manner in which reforms are initiated in the oil sector signal half-hearted attempts. They appear to be initiated without due consideration to the prerequisites. Reforms sans necessary structures and the absence of a regulator could prove to be a dangerous mix. If the experience in other sectors is any indication, problems have surfaced even with a regulator in place. Thus the absence of a vigilant regulator could only make a bad situation worse.

Notwithstanding the drawbacks, the move to open up the oil industry is a welcome development. State control of oil prices presented a structural rigidity in the free market economy. The incumbents and new entrants will now be exposed to the forces of free market. The challenge for them is to learn how to cope with the market risks. Similarly consumers will be exposed to the oil price fluctuations.

As for the future, given the slow pace of progress of reforms, it is highly unlikely that the structure of the Indian oil industry will change dramatically in the near future. It would take a long time before new entrants gain a foothold and alter the market structure. Like other sectors such as banking, the PSU biggies may continue to exist for some time. Eventually the sector may witness mergers and acquisitions and pave the way for a truly free market.

On the international front, the Special Purpose Entities or SPEs, the marvels of financial engineering genius, have acquired a new scent of notoriety and hatred. Enron perpetrated the mother of SPE-abuse by floating around 900 SPEs to successfully shift \$2 bn debt off its books. While Enron indulged in blatant abuse of SPEs on a colossal scale the corporate world in general has been employing them in varying degrees. The common motive appears to be accounting maneuverability rather than any strategic advantage.

There was a notion that SPEs reduce risk. However the Enron case proves that this is just a myth. If it were true Enron would not have found itself in a crisis despite having the protecting power of so many SPEs. What is crystal clear is that SPEs have successfully served the purpose of hiding debt and risk from the public. The truth is that the risk is never mitigated, it is merely not reported.

Ch Rajeshwer

LETTERS TO THE EDITOR**Excellent Coverage of Indian Railways**

I was very happy to read the article on Indian Railways published in the May 2002 issue. The reasons for the poor state of affairs in Indian Railways was well researched. I strongly believe that the Indian Railways should implement the policy recommendations of various groups right now. Perhaps the Indian Railways have a chance to regain their glorious past, if they adopt these policies correctly.

Anjan Biswas
Kolkata

Not a True Comparison

The cover story 'A Tale of Two States' (June 2002) is a progressive attempt to understand the two R's (Reasons and Remedies) for regional imbalances. After the introduction of economic reforms in the 1990s, Andhra Pradesh has performed better compared to Bihar which is yet to start its development process.

In Hindi, *BIMAR* means ill and in the Indian political scene, Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh represent the *BIMARU* states. A comparison between the progressive Andhra Pradesh and the backward Bihar is therefore ill-conceived.

Congratulations to the Analyst cover designer for his eye-catching visual.

Ramu Aravindan
Mullassery House, Ottapalam, Kerala

Enable Professionalism

The article 'Family Businesses – Transformational Challenges' (June 2002) made a very interesting reading. In India, family-run businesses are predominant and with the new economic policies it has become imperative for them to induce professionalism into their business. I think that professionals can bring about a change in the way family businesses are run.

Vamsi Krishna
Bangalore

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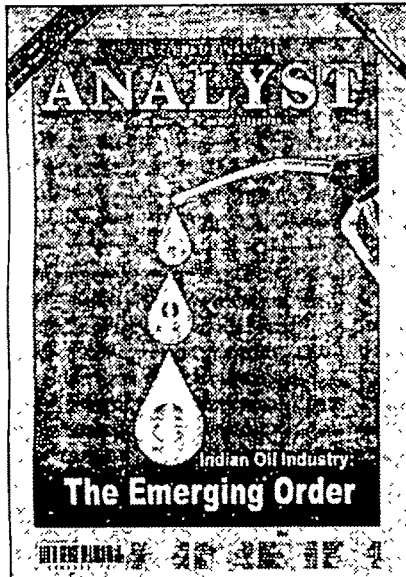


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CHARTERED FINANCIAL ANALYST

COVER STORY



Cover design by S Ganesha

Indian Oil Industry: The Emerging Order..... 21

With the dismantling of APM (Administered Price Mechanism) and deregulation of the marketing and refining sectors, the Indian oil industry has finally opened itself completely to market forces. This would result in increased private and foreign participation. Players with multiple skills and varying capacities are going to reshape the oil industry landscape by redefining the rules of the game. The emerging order will challenge the abilities of the incumbent players and provide ample opportunities for new entrants. Who will emerge as the winner will be determined only after the new market structure fully shapes up.

SPOTLIGHT

Special Purpose Entities

Gasping for breath 16
The growing cases of abuse of the SPE route has rattled the market sentiments in recent times, more particularly after the sudden demise of the US energy major, Enron. Unfortunately Enron was not alone in exploiting the loopholes in the US GAAP. A spate of companies are drawing flak from investors for indulging in such dubious activities. With wary investors increasingly becoming suspicious of anything off-balance sheet, will this mean the end of the road for this financial tool.

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Nissan Motors

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The turnaround of a near bankrupt Nissan Motors silenced many a skeptic as to the logic of Renault's acquisition of the troubled carmaker. After suffering a string of losses for a decade, Renault came to Nissan's rescue and its turnaround master Carlos Ghosn had proved that the faith was not misplaced. Nissan's efforts are now concentrated on establishing itself firmly as a profit churner and chances are that it might soon be.

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India's largest carmaker has the Japanese small car specialist in charge, as the government started its two-phase disinvestment process in the joint venture. The change of guard might bring in greater flexibility and quickness in the way the company responds to its competitors in particular and the industry dynamics in general.

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ROUNDUP

National

IOC going public

The oil refinery major, Indian Oil Corporation plans to tap more than Rs. 15 bn (\$306 mn) through a public equity issue of up to 78 million shares. The issue will constitute up to 10 percent of IOC's current paid-up equity capital of Rs. 7.87 bn and could include an overseas float. "Our board has approved to go in for an initial public offering. We are looking at a price of around Rs. 200 a share, but did not specify a time-frame," says a senior official from IOC. IOC, in which the government owns an 82.16 percent stake, has been on a shopping spree this year in a bid to further strengthen its position in the deregulated scenario. In February, it bought a controlling 33.6 percent stake in another state-run petroleum marketing firm IBP Co. Ltd. for Rs.11.54 bn.

Asia's leading IT players

While India's software industry is busy overcoming policy constraints and an inadequate domestic market, neighboring China, which boasts of having the largest manufacturing base in the world is on the verge of becoming the leading information technology player in the Asia Pacific region, touching \$30 mn. On the other hand, the "Indian software industry is operating under systemic constraints of infrastructure, inconsistent government policy, and inadequate domestic market," according to NASSCOM. In the face of external constraints, Indian software companies need to improve productivity (yield per employee), through better OFT (Organization of Functions and Tasks-capacity utilization), better mix of service lines, standardize processes and develop component libraries. In recent times, there has been substantial news flow about how China poses a significant threat to Indian software industry. NASSCOM conducted a study on the Chinese IT market, with a special focus on the software industry. The study points out that the Chinese Government has shown clear intentions of dominating the IT sector, one of the largest industries in the world.



New Product from TCS

Tata Consultancy Services, Asia's largest global software solutions and consulting services company, has announced the launch of the E.X. Personal Investment Manager (E.X. PIM) – a unique portfolio manager that is integrated with accounting for end to end tracking of investments. E.X. PIM, a new generation personal finance management software from TCS, is targeted at the salaried class, individual investors, business community and professionals.

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- Loans – Housing, car and personal loans with pledge
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It has a host of user friendly features like Payment Alerts which alerts the user for income due dates and maturity dates; Investment Tracker which enables lot-wise and location-wise tracking of investments; and Flexi Deposits which enables the user to maintain deposits having various interest combinations (fixed/floating with varied compounding frequency) with maturity value calculation.

India bans unit of CSFB

The Swiss bank, Credit Suisse First Boston's Indian securities arm was banned for two years for its role in the country's most damaging share-price fixing scandal in a decade. It will serve only another 10 months of the punishment, which has been backdated to April 2001, when the bank was temporarily banned after being accused of manipulating the securities market. This is the first time Indian authorities have banned a foreign financial institution. However, CSFB says it was disappointed with the final decision by the SEBI, and would consider its options. These include an appeal or serving the rest of the ban before re-entering a market which senior executives say is too big to ignore. CSFB's Indian equities brokerage and trading arm was a market leader with a 17 percent share of institutional trades.

Record FDI inflows

India received foreign direct investment worth over \$4 bn during 2001-02, the highest so far, and registered a growth of

66 percent over the previous year despite an economic slowdown that hit the global economy during the year. FDI inflows amounted to \$4.06 bn in 2001-02 as against \$2.46 bn a year earlier. However, the inflows, if recalculated on the basis of international reporting practices, would work out to be much higher than what is currently reported since the FDI inflow figures are based purely on foreign equity investments (including preference shares) other than foreign portfolio investment. It excludes investment by offshore venture capital investors, which in international practices form part of the FDI inflows. In order to align the FDI reporting system with the international computation standards and updating FDI inflows into the country, the government has recently set up a joint committee comprising representatives from the RBI and the Department of Industrial Policy and Promotion. ■



International

Feeble consumer confidence

According to the University of Michigan, the US consumer sentiment index dropped again, based on a survey of roughly 500 US households. The index fell to 90.8 in June 2002 from a final reading of 96.9 in May. The results were preliminary but aggravated concerns about consumer spending. The data compounded fears about the economy's recovery from recession. In a separate report, the Federal Reserve, production from the nation's factories, utilities and mines rose only 0.2 percent last month—the slowest growth since December, when output sank 0.4 percent. All monthly figures are seasonally adjusted. Outside of mining, growth was either sluggish or non-existent. Production of consumer goods was flat for the second consecutive month and output from the nation's utilities fell sharply amid unusually cool weather. The nation's production remained nearly 25 percent below its estimated potential. A report from the US commerce department revealed that US inventories at the manufacturing, wholesale and retail levels sank for the 15th consecutive month in April. A surge in sales across all levels of production and distribution contributed to the lower inventories.



Steel shortage

Further sharp rises in steel prices this year could create a worldwide steel shortage, only months after the industry was mired in deep gloom, according to a leading steel business commentator. World Steel Dynamics, a New Jersey-based consultancy says, world export prices for a tonne of commonly traded hot-rolled coil could rise to \$400 by early next year, up from \$260 now and \$175 in December 2001. The rises are good news for steel producers such as Arcelor of Luxembourg and the Anglo-Dutch Corus, but have sparked anger on the part of big steel users such as Caterpillar, the US maker of construction machines, and Emerson, a leading electronics



equipment producer. World Steel Dynamics in a report says that there are signs of a 'panic' by steel buyers which are seeking to build stocks before prices go up again. As a result, there is a '75/25 probability' of a global steel shortage later this year. The Consuming Industries Trade Action Coalition (CITAC), a Washington-based industry group representing steel users says many of its 2,000 members were "frustrated and worried about where they will get their supplies of steel". Janet Kopenhaver, Director of CITAC says, the tariffs on US steel imports announced in March 2002 had made matters worse. "Without the tariffs, steel prices may well have gone up anyhow—but not by the amount we have seen in the past few months." David Phelps, President of the American Institute for International Steel says, many US companies had to wait nearly three months for steel supplies. "Many steel users that have not planned ahead are in deep trouble," he says.

Japan's economic outlook

Strong exports prompted Japan's Central Bank to upgrade its economic outlook for the fourth consecutive month, but the bank cast doubt on longer-term recovery due to weak domestic spending and dwindling demand from overseas. "Japan's economy shows signs of stabilizing with a distinct increase in exports and a pick-up in production, although domestic private demand remains weak," says the Bank of Japan (BoJ) in its monthly report for June 2002. "However, the pace of recovery is likely to become somewhat slower in the future than at present, as the effects from overseas restocking dissipate," the Central Bank added. It also follows Ministry of Finance data released on June 13, 2002 which shows a 21.7 percent rise in Japan's current account—a broad measure of trade in goods and services—for April year-on-year. The rise came as exports, mostly IT-related sales to the US and Asia, grew by 1.3 percent over the previous year to ¥4,169 bn (\$33.2 bn). Imports fell 3.3 percent during the same period to ¥3,164 bn.



Strong exports led Japan out of its worst recession in decades, spurring GDP growth in January to March 2002 quarter and ending three straight quarters of decline.

On the recovery path

Thailand's economy grew faster than expected in the first quarter, suggesting that the recovery was picking up strength, according to figures released by the state-planning agency. It climbed 3.9 percent, year-on-year, on vigorous consumer spending fueled by cheap money, more investment, a release of pent-up demand and government stimulus. The National Economic & Social Development Board also lifted its 2002 GDP forecast from 2-3 percent to 3.5-4 percent after a review of the global economy. GDP expanded 1.8 percent last year. "Thailand has been moving slowing in the right direction for a long time. This confirms that it has finally picked up momentum and that it won't be easily derailed," says Kenneth Ng Head of Research at ING Barings in Bangkok.



The corruption scale

A survey conducted by Transparency International, an anti-corruption organization, says companies from the US and Japan are at the forefront when it comes to paying bribes to get work done in developing countries. In its Bribe Payers Index, 2002, the US score of 5.3 out of a best possible clean 10, is matched by Japanese companies. It is worse than the scores for corporations from France, Spain, Germany, Singapore and the United Kingdom. The highest scores indicating the lowest propensity to bribe abroad, were achieved by firms from Australia, Sweden, Switzerland, Austria, Canada, the Netherlands and Belgium. The Bribe Payers Index is based on surveys conducted by Gallup International Association in 15 emerging markets, including India, Argentina, Brazil, Colombia, Indonesia, Mexico, Nigeria, and Thailand. ■

N Janardhan Rao, Team Analyst

Merger street

Bertelsmann acquires Zomba

Bertelsmann, the German media group, is to acquire Zomba, the music company behind such stars as Britney Spears, 2Pac and Frank Zappa, for close to \$3 bn. The move will strengthen Bertelsmann's own music business but restrict its ability to make other acquisitions. It is also likely to dampen expectations that Bertelsmann could be preparing a bid for television assets in the UK and further music or magazine acquisitions in the US. Company sources maintained that Zomba had exercised a "put" option forcing BMG. Bertelsmann's music business and the smallest of the five music majors, to acquire the shares it does not already own in the business. Zomba and BMG have had ties since the mid-1980s and the company founded by music producer Clive Calder has been Bertelsmann's best source of talents in recent years, contributing such acts as Ms Spears and NSYNC to BMG's roster. In 1991, Bertelsmann acquired a 25 percent stake in Zomba's music publishing division and in 1996 it bought 20 percent of its record division. The transaction will increase the profitability of BMG, which has suffered from poor demand and is in the midst of a painful restructuring. The unit had a net loss of €43 mn (\$40.7 mn) in the six months to December 2001 on sales of €1.6 bn. The deal will stretch the finances of Bertelsmann, which will shortly issue a €1 bn bond, its first benchmark-sized debt issue. The group is now expected to have net debt of about €4 bn by the end of the year. Ratings agencies have said Bertelsmann's BBB+ credit rating or equivalent could only be maintained through disposals should the option be exercised, which should limit Bertelsmann's ability to grow by acquisition in the short-term.



would further strengthen DnB's position as Norway's leading financial institution and fulfill the Government's dream of having a national champion based on DnB. The Government has been hostile in the past to takeovers by foreign banks. According to people close to the talks, DnB is prepared to offer slightly fewer than 1.5 DnB shares for every Storebrand share, or about Nkr65 per share, less than what DnB indicated last year in its merger approach. Still, it is much lower than the Nkr75 per share at which Storebrand could have been bought last year had DnB not blocked a takeover bid by Sampo of Finland. DnB used its 10 percent stake in Storebrand to prevent Sampo from getting the needed 90 percent to buy any Norwegian financial institution. This had led some to believe that the soured relations between DnB and Storebrand would prevent the two from being able to do a deal in the future. However, since then DnB's share price has strengthened, while Storebrand has fallen. Meanwhile, impatience among Storebrand shareholders, some of whom also own shares in DnB, has grown so strong that DnB was prompted to initiate the deal. DnB is also under pressure to do a deal with Storebrand now before Norway changes the ownership rules later this year to allow financial institutions to own less than 90 percent of another and thus facilitate the possibilities for takeovers. DnB is believed to have justified paying a lower premium than last year's unofficial bid by granting concessions to Storebrand management. The transaction would lead to substantial synergies for the combined group. According to DnB's calculations last year, cost synergies could reach around Nkr600 mn, not including the value of potential revenue synergies, particularly within banking operations.



DnB in a \$2.2 bn deal

Den norske Bank, Norway's largest bank, is expected to offer up to Nkr18 bn (\$2.2 bn) in stock for Storebrand, Norway's largest insurer, if merger talks are successfully completed. A merger

due in July. The question of how the banks and France Telecom divide MobilCom's debt between themselves has been the most difficult issue holding back a deal between the French operator and its German partner. The four main banks to MobilCom—Deutsche Bank, Merrill Lynch, ABN Amro and Société Générale—have agreed among themselves and also with France Telecom the basis for the refinancing of the \$4.2 bn debt, which will become convertible into France Telecom equity. However, the 13 other banks in the 17-bank syndicate are now examining the proposed terms of the security, which will only convert into France Telecom shares at a premium to the current share price. The management teams of both France Telecom and Orange, its listed mobile subsidiary, will face fierce questioning from shareholders. By assuming MobilCom's debt, France Telecom would be adding a further \$6 bn-\$7 bn to its own existing financial obligations of about \$61 bn. Its shares have fallen 54 percent since January on concerns over its high gearing. It is expected that Orange, which already owns a 28.5 percent stake in MobilCom, will buy up the remaining shares.



MetLife to buy Ahisa

MetLife, the US financial services group, will acquire Aseguradora Hidalgo (Ahisa), Mexico's second-largest insurer, for \$9.2 bn pesos (\$962 mn), in one of the most successful Mexican privatizations in years. The acquisition, which follows an auction in which MetLife outbid Mapfre of Spain and Inbursa of Mexico, will take the company's share of the Mexican insurance market from 4 to 15 percent, ranking it only behind ING of the Netherlands. It also continues the rapid entry by US and European companies into Mexican financial services. The sale continues a policy of expansion in Latin America for MetLife, which has had a presence in Mexico for a decade. More recently, it has bought or acquired



France Telecom to buy MobilCom

France Telecom is close to an agreement to take over MobilCom after the German mobile operator's four main banks agreed to restructure \$4.2 bn of its debt

businesses in Argentina, Brazil, Chile and Uruguay. Ahisa specializes in group policies for employees in the public sector, an area in which MetLife also specializes, and so the combination appears to be a natural fit. MetLife is paying a rich multiple of 14.8 times last year's earnings, after adjusting for extraordinary events of last year. However, Ahisa's status as the monopoly provider of insurance to Mexico's public-sector workers may justify a higher multiple than would be paid for other companies in the sector. Following an agreement with Mexico's Federal Competition Commission, which blocked an earlier attempt to sell Ahisa, the company will be allowed to keep its exclusive government contracts until the end of 2004. This gives MetLife 30 months to make changes to its salesforce to make it ready for competition. The sale is the first privatization since President Vicente Fox came to power in December 2000, and is a notable success for the Government, as the price paid is at the top of expectations.

Croatia puts INA on sale

Twenty international oil and gas companies have bid for a stake in INA, Croatia's oil and gas monopoly, and one of the largest such businesses still in state hands in the Balkans. The Croatian Government is selling 25 percent plus one share in INA as part of its energy sector reform. The company has been valued at between €1.2 bn and €1.8 bn (\$1.12 bn-\$1.69 bn) by Deutsche Bank and PwC, the advisers. It is one of Croatia's most valuable assets to come up for sale since the privatization of the pharmaceuticals and telecommunications companies. MOL of Hungary, OMV of Austria, Eni of Italy and Russia's Lukoil are believed to be interested. The Government has been under pressure from international organizations such as the International Monetary Fund and European Union to carry out privatizations. However, privatization, particularly to foreigners, is unpopular domestically. INA, which had been losing money until last year, requires large investment. It has two refineries, which have investment needs of some \$360 mn over the next three years, according to company sources.



Instinet buys Island

Reuters, the UK global information provider's majority-owned electronic trading platform Instinet had agreed to buy rival Island ECN in an all-share deal valued at \$508 mn. Instinet will pay its shareholders a special dividend of \$1. Island shareholders will end up with a 25 percent stake in Instinet. Instinet's move for its rival will expand its market share of trade in NASDAQ-listed companies to around a fifth and give it a larger base of traders and investors. Instinet's customer base is concentrated on institutions, whereas Island has attracted more day-traders, hedge funds and smaller brokerages. Island is the industry leader among the so-called Electronic Communications Network (ECN), upstarts who used sophisticated low-cost trading platforms to take on Instinet. The new enlarged trading platform also promises greater liquidity at a time when all brokers are being squeezed by the sharp fall in the stock market since the technology boom of 2000. Reuters' shareholding in Instinet will fall to 62 percent from 83 percent on the deal. It would receive \$207 mn from the payment of the special Instinet dividend.



Murdoch to buy Telepiu

Rupert Murdoch is to pay €1.5 bn (\$1.4 bn) to take over Vivendi Universal's Telepiu pay-TV unit in a deal that will see News Corp become the sole pay-TV operator in Italy. The agreement, however, hinges upon News Corp finding other investors that would reduce its stake in the venture to 50 percent, and upon approval from Italian and possibly European Union antitrust regulators. According to sources Telecom Italia, which owns half of Stream, will agree to spend cash and increase its stake in the combined group. The accord ends months of bitter talks and threatened legal action between the two rival media chiefs while both their Italian operations piled up massive losses. Vivendi's Telepiu and News Corp's Stream last year lost an estimated €750 mn combined, and are on track for a similar loss this year. Vivendi last winter



agreed to acquire Stream from News Corp, but last month canceled the deal when Italy's antitrust authority imposed conditions that Vivendi said would not easily allow it to make a profit. Under pressure from ratings agencies to slash its borrowings, Vivendi said the transaction would reduce its €17.1 bn debt by €1.2 bn. But the deal also marks another setback for Jean-Marie Messier, Vivendi's embattled Chief Executive, who has abandoned Canal Plus's ambitions for Telepiu, the market leader in Italy. Canal Plus last year lost €500 mn at the operating free cash flow level. News Corp will pay €650 mn in cash if the deal is completed, probably during the last quarter of this year. It will also assume €550 mn in debt and pay off a €300 mn loan in five years time that Vivendi made to Telepiu.

Heinz to spin off brands in \$1.8 bn deal

HJ Heinz is spinning off some slower-growing businesses and merging them with fellow US food company Del Monte, in a \$1.8 bn deal the food giant hopes will transform its growth prospects. The maker of Heinz Tomato Ketchup and Baked Beans has been under pressure to act to perk up sales and earnings growth, after three years of little progress. It will spin off its North American pet food and pet snacks, US tuna, US private label soup and infant feeding businesses. Brands to go include Kibbles 'n Bits, 9-Lives, StarKist and Pup-Peroni. The spun-off businesses will be merged with Del Monte in an all-stock transaction, with Heinz shareholders getting 0.45 Del Monte shares for each Heinz share. Heinz will offload \$1.1 bn debt on to the new company. Heinz shareholders will be left with 74.5 percent of the new Del Monte, and Del Monte shareholders 25.5 percent. Heinz was left out of the food industry merger wave of 2000, raising questions about its strategy. It has been criticized for hanging on to businesses such as StarKist, holding back its overall growth. ■



D G Prasuna, Team Analyst

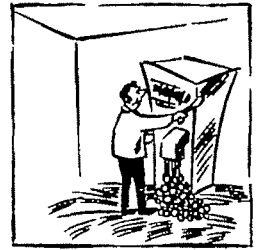
TICKER

With the advent of new products and services, the banking industry has never looked back. Newer and better schemes evolving in this industry has even caught the eye of our Government. Special Purpose Vehicle is one such invention, also called a "bankruptcy-remote entity". Special Purpose Vehicle (SPV) is usually a subsidiary company with an asset/liability structure and legal status that makes its obligations secure even if the parent company goes bankrupt. Problems arise when CFOs take undue advantage of the accounting loopholes to hide debt and thus follow the practices of window dressing. It could be devastating if things go wrong, as was seen in the Enron case. Thanks to Enron, SPVs are household words.

Yashwant Sinha has proposed to finance the infrastructure projects of the country through SPVs. He had a meeting with the chiefs of Life Insurance Corporation, State Bank of India, Industrial Development Bank of India, Infrastructure Development Finance Company and ICICI that have been identified for financing infrastructure projects through SPVs initially, with other institutions and banks in the pipeline to be roped in later. The banks would have to take decisions

SPVs: The New Mantra

regarding the project and debt-equity pattern individually. The estimates work around Rs. 40,000-50,000 crore, needed to be raised over a period of five years. Such financing seems to be sector-specific and extension of this scheme to other projects is a matter under discussion. The inferences from the finance ministers' statement show that the funds would be made available to those sectors in which government spending is high. Railways, rural roads, roadways, ports and urban infrastructure projects come under this purview. It is proposed that the banks and financial institutions should work on a co-ordinated basis in financing the infrastructure projects. Budget 2002 has seen more initiatives on infrastructure development and also includes a sanction of Rs. 1000 crore for infrastructure equity fund under IDFC which stands to be its nodal agency. However, the captive industry will always survive by adapting quickly to a changing risk environment.



A Ravi Shankar

One of the largest software companies in the world, Computer Associates, received a major blow when SEC started investigating its accounting policies. Computer Associates' main strategy has been to buy other firms, sack all the employees and enforce software-contract rights. In 2000, the company changed its auditor and the manner in which it accounted for software contracts. The company's accruing practices raised suspicions on the way it presents its financial statements. The company has recently stopped disclosing such figures, which would help the investors in comparing the company's present performance with that of before the change of the accounting practices.

Two years earlier, Computer Associates had paid its top executives an immodest sum of \$1.1 bn worth of its stock to its top executives. The amount was tied to the performance of the stock price of the company. The compensation plan was such that the top executives will be paid a sum of \$1.1 bn if the stock price stayed above \$53.3 for a period of more than 60 days during any time in the 12-month period. The target was reached on May 21, 1998. The payment was followed by lawsuits filed by the shareholders of the company. The shareholders were, in particular, fed up by the fleeting nature of the company in acquiring new

software companies. Exactly, two months after the payment, the company issued a profit warning. As a result, the company's share price collapsed. Now the shares of the company are traded below \$20. The executives returned more than a sum of \$250 mn of their award because Computer Associates failed to insert a clause in the compensation allowing the payout to be adjusted to the stock splits. This symbolized the end of the smugness of the bigheaded Charles Wang, founder, Computer Associates.



Wang should also face the impending return of Sam

Yet Another Accounting Chicanery

Wyly, the man who headed the militia to launch a proxy fight for control of Computer Associates' board. But he could win only 25 percent of the vote. Wyly's through his vehicle, Ranger Governance, has already attacked the sales and customer service practices. This time Ranger is beefing up to attack the board, which according to Wyly lacks independence. Only future can say the fate of the beleaguered software giant whether it could be able to settle all the cases filed with the SEC and could regain the past glory or not.

Sharath Jutur

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COUNTRY SCAN

The Netherlands

Dutch glory

The Netherlands is one of the most developed countries in the world. A country with limited natural resources, much of the modern Netherlands has been reclaimed from the sea. In the past 20 years, the Dutch economy has grown impressively at an average of three percent. Through most of the 1990s, the Dutch seemed to have mastered the art of combining high growth rate, low unemployment and low inflation.

The Netherlands was one of the superpowers of the world in the 17th century. The Dutch East India company was the world's first multinational. The Dutch extended their presence to the Moluccas, Ceylon, Formosa, parts of India and Nagasaki in Japan.

By the 19th century, the Dutch had slid into relative oblivion. Late to catch on to the industrial revolution, the country entered the 20th century primarily as an agrarian economy. The German occupation during the second world war probably saw the Netherlands hitting a trough. In 1953, the southern dikes were breached, killing some 2000 people.

Since the 1950s, the Netherlands has come a long way. In 1959 gas reserves were discovered off the northern coast of the Netherlands. But this had a mixed impact. Exports did pick-up. But it also triggered off public spending, a sharp appreciation of the guilder and the construction of a welfare state. In 1982, the budget deficit touched over seven percent of GDP. It was then that the workers, businessmen and the government got together. The accord signed in Wassenaar, a suburb of the Hague proved to be a turning point. It paved the way for pay hike restraints and decentralized bargaining.

In 1983, unemployment was 11 percent. But it steadily declined. From the mid-1980s, the tight pegging of the Dutch guilder against the DM resulted in monetary discipline. Fiscal restraints were also put in place.

In recent times, the Dutch economy has looked a lot less healthy. Inflation and unemployment are both rising. Many Dutch citizens are also unhappy with the country's excessively liberal policies concerning issues such as immigration, drugs and prostitution. Since the Dutch economy is outward-oriented, the slowdown in the global economy in recent times has also had a significant impact.

Economic policies

The Dutch economic model has impressed many observers. In the past 20 years, the country has quietly but surely introduced flexibility in the labor markets. Unemployment is currently less than two percent down from the peak of 11 percent in 1983. Government spending has been tightened. In 2001, the government recorded a budget surplus of 1.1 percent of GDP compared to a deficit of over seven percent of GDP in 1982. Public debt is now a healthy 51 percent of GDP compared to 76 percent in 1988. Taxes have come down. Dutch health care reforms have also been very innovative. In other social services such as education, the Dutch have increased the role of the private sector and injected an element of competition. But fiscal restraint may be harder to achieve in the coming years as there are increasing demands on public services.

The Dutch imposed monetary discipline on their system by a tightpeg of the guilder to the DM. In 1992, the European Exchange Rate Mechanism

(ERM) faced a crisis. The UK, Italy and Greece withdrew from the ERM. And all the other countries widened the band within which their currencies oscillated against the DM. But, the guilder continued to move within a narrow range. Indeed, the German Bundesbank had so much confidence in the Dutch that it was the most ardent supporter of Wim Duisenberg (a Dutchman) for the candidacy of president of the European Central Bank.

The Dutch record in employment generation is commendable. Workforce participation as a percentage of the total working population is 74 percent, ahead of even the US. This figure was only 52 percent in 1982. The growth in part-time jobs is an indication of the growing flexibility of the Dutch labor market. But the participation rate of older people is very low. Presumably, this is due to a generous social security system that has created disincentives for unemployed people to get back to the workforce.

The Dutch need to take a serious relook at their disability scheme. A ridiculous one million out of a total population of seven million people qualify for this scheme. Quite clearly, many people have taken unfair advantage of the system. Employers on their part have looked at the scheme as a cheap and easy way of getting rid of surplus workers. There is also a feeling that the official unemployment figures are grossly understated. In recent times, the rules for claiming unemployment benefits have been tightened. But, the number of new entrants into the scheme, after falling for sometime has again risen. This is because the benefits are still high and monitoring is not very rigorous. The Dutch need to summon the necessary

The Dutch record in employment generation is commendable. Workforce participation as a percentage of the total working population is 74 percent, ahead of even the US.

political will to introduce more radical reforms in this regard.

The Dutch have introduced several innovations in their health care system. The country believes in universal coverage through compulsory social insurance. But almost 75 percent of Dutch hospitals are private establishments. Two-thirds of the population are enrolled compulsorily in one of the country's health-care funds. The remaining are covered by private insurance. Patients can switch their insurers once a year. Insurers can contract with doctors and hospitals of their choice. This has aimed at introducing competition into the health care program and yet ensure universal coverage at low prices. But tight cost control by the finance ministry, combined with a limited supply of doctors has resulted in customer disgruntlement. Despite these limitations the Dutch system seems to be more customer-oriented than in the US, where cost-cutting is the norm with HMOs dominating the scenario.

Education is another area where the Dutch are trendsetters. 70 percent of the schools in the country are privately owned. The Dutch have a lot of choice while selecting schools for their children. Management of schools is decentralized.

Social policies

Dutch social policies have been highly radical. Take the case of drugs. Instead of putting curbs, availability of drugs in coffee shops has been increased. Though growth and sale of drugs is still illegal, no legal action is taken against coffee shops which stock up to 500 grams of cannabis and sell not more than five grams to one person. Surveys show that cannabis use has decreased in recent times. Moreover, the Dutch policy makers feel that the ready availability of cannabis has helped prevent the use of hard drugs. Indeed, heroin abuse is much less prevalent in the Netherlands, compared to Britain and many other European countries. The Dutch have legalized prostitution. In 2000, brothels were made legal. But there is no evidence that prostitution has increased. On the other hand, tourist inflows have picked-up. Moreover, tax collection has increased and the police have found it easier to drive away illegal immigrants in the prostitution business.

The Netherlands was one of the first countries in the world to legalize abortion. But it has also attempted to discourage abortion through sex education. So, the country has one of the lowest abortion rates in the world.

The Dutch have promoted gay rights, more enthusiastically than any other country in the world. Marriage between gays was legalized in 2001. The normal civil marriage laws apply to gay couples.

The Dutch have led the way in euthanasia. Doctors can assist patients in committing suicide provided they follow a code of conduct. Like drugs, incidents of euthanasia have not risen sharply since it was legalized. Monitoring has been good and on an average, two out of three euthanasia requests are rejected.

Business and industry

The Dutch have a long tradition of trading and investment. In terms of tonnage handled, Rotterdam remains the largest

The Dutch have a long tradition of trading and investment. In terms of tonnage handled, Rotterdam remains the largest port in the world

port in the world. The country has produced several famous MNCs like Philips, ABN-Amro, Royal Dutch/Shell and Unilever. The core of the economy, however, consists not of giant enterprises but small businesses. Agro-based industries are very important for the Dutch economy. Beef, pig meat, chicken and dairy

products are major exports. Horticulture is also important. The Netherlands is the fifth largest foreign investor in the world after the US, Britain, France and Germany. The country is also one of the most attractive investment destinations in the world.

In housing construction and food processing, the Dutch lead the world in productivity. So, there is considerable scope for globalization. But the housing sector has faced a serious problem owing to shortage of land. According to the McKinsey report, in the mid-1990s, roughly 70 percent of the land was available for agriculture, 13 percent for nature, nine percent for infrastructure and commerce and less than eight percent for housing. This has acted as a dampener on housing construction.

In services, the Dutch are making impressive strides, led by banks like ABN Amro, ING and Robobank and retailers

like Royal Ahold. But Dutch financial institutions are far less innovative compared to their American counterparts. Moreover, in manufacturing, the Dutch are weak. Many Dutch companies are comfortable operating in the US, the most important market in the world both in terms of size and strategic significance. Indeed, many economists consider the Netherlands to be the most Anglo Saxon country in continental Europe. Quite a few Dutch companies have English as the official language.

Understanding the Dutch

- The Dutch are imbued with community spirit. So, collective decision-making is the norm.
- Retrenchment is difficult but if people are handled well, it can result in a highly motivated workforce.
- The Dutch respect hierarchy. So, it is desirable to define roles clearly.
- The Dutch workforce is generally educated, multilingual and computer literate.
- Investment agencies are proactive and professional.

Future outlook

Quite clearly, the pragmatism shown by the Dutch in solving their economic and social problems has been impressive. The country's citizens enjoy a high standard of living. Businessmen seem to be generally happy with the degree of flexibility in the domestic labor market. Nevertheless, there are some clouds looming on the horizon. Many Dutch people are unhappy with the inflow of immigrants. The rise of the late Pim Fortuyn is part of this phenomenon. Fortuyn attacked immigration policies in general and Islam in particular. His popularity is a clear indication that many Dutch do not like multiculturalism. Fortuyn's recent assassination has sent shock waves as it is the first political murder in the Netherlands since the 17th century. At a broader level, some analysts feel that dissatisfaction with the mainstream political parties that stand for consensus is growing. Dutch political leaders seem to lack charisma and are short on new ideas. The Dutch public want an upgradation of social services. The new government has to live up to all these challenges. ■

A V Vedpuriswar, Deca,
ICFAI Knowledge Center, Hyderabad

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INTERVIEW

"Accounting frauds have become more of a rule these days than exception. Who is responsible for this state of affairs? Are the regulators geared up to check these creative accounting practices."

S Santhanakrishnan, Partner, Sridhar & Santhanam, Chennai, and Member, The Central Council of Institute of Chartered Accountants of India.

□ How far are the auditors responsible for the continuing saga of accounting frauds?

They are the Big 4 and they keep moving from one place to another! Andersen, which was no doubt, good, became bad because of Enron, overnight. (Till last year they held the no. 1 spot in surveys of good auditors among accounting professors, now EY holds the no. 1 name for quality) Andersen, let us say, merges with EY—at least in India—and look! They have become good again overnight!

There is no system of audit in the past, present or any time in future which will locate all frauds in companies. Such an audit system did not, does not and will not exist! Understand that! Myth (people's faith) that Big 5 have the skills, abilities, talents and tools to do a good audit has been completely wiped out by such issues. The natural question is, what is the value for money and the benefit realized for such high fees that they are charging?

□ How far are the Board of Directors responsible for this pitiful state of affairs?

If it is something which keeps happening with regularity then you must know something deep down is wrong. If the top management decides to take shareholders for a 'walk' and collude to do things, it is not easy for an auditor to find out all that is going on. If the Board knew something or could have known (something like many off-balance sheet partnerships in Enron) and they do not question that, then it is wrong. Otherwise how are they supposed to know that a CEO is say 'Channel stuffing'. The responsibility falls squarely on the top management and the full time executives on the Board. They are the culprits. How do you ensure that the culprits learn their lessons? PUNISHMENT. That is the only thing that will help. You need to put the guy behind bars to ensure he/others learn a lesson, once proved

guilty. Auditors in specific cases could be probably accomplices; both the culprit and the accomplice should be punished.

□ Is it ethical on the part of the SEC to let off the financial fraudsters with just a fine?

I agree. Some one has to pay for this and not the poor shareholders. They have been cheated and they have lost their hard earned money and look, they have to also bear the penalty!

Take the case of Xerox. Xerox dupes its shareholders and they get cheated. Then Xerox pays a \$10 mn fine, making shareholders poorer. This is a big joke. SEC looks at the largest fine it has collected!

□ How far is the pace of change in regulations able to match the pace of emerging 'innovative' earnings management tactics?

In my opinion the research committee of the CA Institute should come out with immediate pronouncements in new and in doubtful areas. Even if the standards take time to evolve, at least there will be an application of mind and will not be left to the management to deal with it the way they want.

Now note that The Big 5 (now 4) have 5,27,000 employees worldwide and had a revenue of \$46 bn last year (much more than our entire forex reserves!). They are a rule unto themselves. I have nothing against them; If they are that big, it is also because

they are good. But we all know power corrupts. Let us see regulation and how it works. The Big 4 employ only around five percent of all CPAs in US. But they control over 10 percent of the State Boards which oversee the profession, act as watchdogs, grant and revoke licenses and investigate companies. What kind of independence/justice do you expect? Except Deloitte Touche, in all other Big 4, partners are aggressive and have targets to meet, they get

paid if they bring consulting work; What independence is possible if I am going to always dread losing a client?

The change has to take place with the regulators and with the standard setters rather than saying we need a new set of regulations / new standards.

□ Where does SEBI stand in comparison to SEC in this area?

We can confidently say that SEBI is slightly better than SEC on various counts. In our case we also have size as an advantage. We have only one Fortune 500 company in public sector and one, now in private sector. Otherwise (but for UTI) we have had only minor disasters which we could grin and bear. (not that in UTI we are doing anything else!) If a public sector/co-op sector bank goes down, the Government pumps in money. It supports the bank in some way or the other. So we do not have that much big problems arising out of size here. Also death of a company is a slow, painful process here.

SEBI has to select a few companies where profits/prices are going through the roof and where there are signs of stress (like cash flow problems, too much current assets, new project implementation etc.) and subject such companies to investigation. They should also select some potentially sick units and see how bad things are. The case in point is a company's balance sheet before and after going to BIFR. There will be a lot of clean up, because they know BIFR will protect them; no legal cases; concessions from banks/FI etc. Does anyone ask why there is such a big difference in reported profit/losses in one year? SEBI can use a panel of reputed CAs themselves including the Big 4 and use them fruitfully to get at the truth. When and if something is established, SEBI take it up seriously with the Institute of Chartered Accountants of India (ICAI). It is an independent body and is a much better and decisive body than the US counterpart. Use ICAI for both deterring and investigation. ■

The charge has to take place with the regulators and with the standard setters rather than saying we need a new set of regulations / new standards

Basle Norms

Catching up in India

RBI's new draft guidelines for country risk management would go a long way in adhering to the international norms.

It looks like the Indian regulators are catching up with the recommendations of the Basle Accord. Though the Basle Committee consists of representatives and supervisors of the G-10 countries, its recommendations are taken seriously and are followed by most of the countries. The Basle norms act as the benchmark reference to the other countries. The Basle Accord of 1988 became an accepted world standard with over 100 countries applying the Basle framework to the banking system. This accord brought standardization in the banking system and created a level playing field for banks.

Since 1988 there has been a lot of changes in the banking arena. Innovations were brought in to circumvent the guidelines. Some of the banks in the developed world have developed advanced risk management tools which were superior to the ones recommended by Basle. To keep in tune with the tide, the Basle Committee has framed new guidelines which would be implemented from 2004 after receiving feedback from various banks.

While the time set to move to the complete adherence of the new accord is 2004, the countries in the core group are already implementing some of the guidelines. One such guideline is on country risk management. Reserve Bank of India has started the consultation on this point and invited views and comments before June 15, 2002. The proposal would be implemented from March 31, 2003.

It is seen that RBI is not satisfied with adequate policies and procedures for identifying, monitoring and controlling country risk by banks in their international lending and investment activities. It is seen that few public sector banks had not introduced country risk exposure monitoring system. Many of these banks did not even have a robust reporting system for country exposure. Few banks

had fixed country risk exposure limits. These limits wherever fixed were a proportion of capital and reserves. Some of the banks had not furnished the rationale or fixing country exposure limits. A few banks have adopted country risk classification put out by Euromoney or Dun and Bradstreet.

According to the Advisory Group on Banking Supervision which submitted its report in July 2001, which undertook a detailed analysis of the level of compliance on the country risk, the gross exposure of public sector banks is Rs. 52,046 crore and the gross exposure for new private sector companies is about Rs. 7057 crore. So what would be the effect of provisioning on these banks? According to the risk weights classified, ranging from 0.25 percent to low-risk countries to 20 percent to high-risk countries, the additional provisioning requirement would be Rs. 378 crore for public sector banks and Rs. 28 crore for new private sector banks. This provisioning was considered achievable for banks. It is observed that in few countries the regulators have prescribed the rate of provisioning and in some the rate of provisioning has been left to the discretion of the banks. It is seen that the band of provisioning in Belgium is from 10 percent to 60 percent. In Canada, the minimum provisioning is 35 percent. In Italy the provisioning ranges from 15 percent to 60 percent. Going by this data the provisioning in India is far less.

According to the new draft guidelines on country risk management, banks should formulate appropriate well-documented and clearly defined Country Risk Management (CRM) policies and the approval of the respective boards. The CRM policy should address issues of identifying, measuring, monitoring and controlling country exposure risk. The banks should reckon both funded and non-funded exposures from their domestic as well as foreign branches. Indirect country risk should also be



considered and the exposure should be computed on a net basis (gross exposure minus collaterals, guarantees etc.).

To begin with banks are allowed to adopt sovereign ratings of international credit rating agencies but eventually the banks are expected to put in place appropriate systems to move over to internal assessment of country risk. Six risk categories have been identified—insignificant; low; moderate; high; very high and off-credit. The provisioning is from 0.25 percent to an insignificant risk country to 20 percent to an off-credit country. The banks should monitor the country bonus on a weekly basis before moving to real-time monitoring.

This particular move would undoubtedly improve the risk management in banks but on the down side the underdeveloped and the developing nations feel that it is an evil as it would not encourage banks to lend to these countries due to higher provisioning requirement. ■

Related Article:

- 1 The New Basle Accord – More questions than answers, *Analyst*, March 2001

D Satish, Team *analyst*

Reference # 1-2002-07-03

SPOTLIGHT

Special Purpose Entities

Gasping for breath

The post-mortem report of Enron, the czar of all financial frauds, just shows how blatantly the company flouted accounting norms, creating several off-balance sheet entities, deceiving millions of investors. With investors increasingly becoming wary about accounting practices, will this mean an end of the road for SPEs?

If there is one thing, which might be troubling the mighty SEC (Securities and Exchange Commission) today, it must be the legacy which Enron, once an icon of corporate America but now a bankruptcy case, has left behind. Out of many skeletons, which have come out of the energy-trading company's cupboard, the most mysterious is the web of surrogate offsprings it created in the form of Special Purpose Entities (SPEs). The post-mortem report of Enron's financial frauds shows how blatantly the company flouted accounting norms and set up several of (about 900) off-balance sheet entities, in order to inflate its earnings numbers for years before the party got over for it.

Unfortunately Enron was not alone in exploiting the gaping loopholes in the US GAAP (Generally Accepted Accounting Principles). A spate of companies ranging from the now much maligned Tyco International to General Motors are drawing flak from investors for indulging in such dubious activities. In a way, the sudden demise of the energy-trading giant has opened a can of worms. With more and more big corporate accounts coming under market scrutiny, a slew of such accounting malpractices is coming to the fore. This has sent markets into jitters, with wary investors increasingly becoming suspicious of anything which is off-balance sheet (growing concern about motives behind setting up such entities has led to investors pulling down stock prices of even the top-rung firms like General Electric and General Motors).

Does all this mean the end of the road for this financial tool called off-balance sheet entities? What remedial measures are needed to reduce if not eliminate instances of abuse of off-balance sheet accounting by companies.

Though it would be hard to say that SPEs are created only with so ne dubious motives, it is true, at the same time, that

this practice has raised enough concerns about its genuine application by greedy corporates. While opinions vary on the viability of SPEs, one thing every one agrees upon is: It is a useful instrument and should not be scrapped. Agreeing with the popular perception, Richard Wayman, President, Research Stock (a US-based stock market research firm) says that it is true that the SPEs channel has been abused, but that should not lead to its elimination; what is required is a revision in the overall provision of the regulatory framework dealing with it. Of course, they do say that some amount of screw tightening is warranted. But will that be enough to rein in the tricksters?

SPE – The growing abuse

The growing cases of abuse of the SPE route has rattled the market sentiments in recent times, more particularly after Enron. Enron floated around 900 SPEs to keep huge amounts of debts, running into billions of dollars off its balance sheet. This not only helped the company hide potential liabilities from the markets but also inflate its earnings numbers. It overstated its earnings by about \$600 mn since the fiscal year 1997. After the company's sudden disclosure about its inflated earnings numbers in October 2001, it also revealed that it had to reduce its equity capital by about \$1 bn.

More recently, another US company, Adelphia Communications, revealed its murky off-balance sheet deals. The sixth largest cable TV service provider in US disclosed its off-the-book dealings with its founders, the Rigas family, which weren't approved by the board. The founding family borrowed the money from banks, with Adelphia guaranteeing the loans, meaning that potential liabilities lies on the company. The off-balance sheet debt amounted to about \$2.3 bn. Adelphia has admitted that Highland Holdings, a partnership owned by the Rigas family,



borrowed money against credit facilities co-guaranteed by Adelphia. Some of the money was used by Highland to buy more shares of Adelphia. Besides, the company also has admitted that it could be liable for \$500 mn in loans to Adelphia Business Solutions Inc. (ABIZ), a local-telephone provider, which it spun off in January this year. ABIZ filed for Chapter 11 bankruptcy protection last week. The company also said that the involvement of the Rigas family in ABIZ could represent conflicts of interest.

The SEC's investigation apart from other accounting juggleries indulged in by the company also focuses on an important transaction through which it was allegedly trying to reduce debt on its own books. The transaction involved a transfer of digital converter boxes to a special purpose entity owned by the Rigas. It is alleged that Adelphia made a bulk purchase of set-top boxes at a discount, and transferred \$100 mn worth of boxes to that Rigas' partnership entity. Surprisingly, though the said partnership paid for the boxes in the form of a company receivable, it is alleged that it didn't need the boxes for its own operations. The transaction had the net

effect of artificially reducing Adelphia's liabilities by placing the non-required goods in the special purpose entity.

The story of imprudence by the company, however, does not stop here. In its filing with the SEC, the company also accepted that it had 47,253 fewer cable customers as of December 31, 2001 than it had reported. As a result its operating profit (earnings before interest, taxes, depreciation and amortization) had to be restated by \$210 mn and \$160 mn for the fiscal years 2001 and 2000 respectively.

The Adelphia case once again brings to the fore the issue of conflict of interests regarding the auditing firms which perform the dual role of auditors as well as consultants, as seen in Enron case where Andersen drew flak for its dubious role in Enron's financial alchemy. Experts opine that Adelphia's auditors Deloitte should have known about the debt and asked the company to disclose it as it had audited Adelphia and several of the Rigas promoted entities.

With several big names getting mired in the controversy, investors are increasingly becoming wary of the use of SPEs by companies. And, with Wall Street getting inundated with cases of abuse of SPEs by companies in recent times, it is clear that their concerns are not unfounded. The verbal duel between Bill Gross, the famed bond manager from the world's largest bond management company PIMCO, and General Electric over the lack of enough information about the functioning of GE Capital, the financing arm of the company, is all too well known. Dell Computers, another high-flying company, is drawing flak for its off-balance sheet deal with Tyco International's financial subsidiary CIT. The markets got apprehensive of Dell's funding mechanism to achieve such robust growth year after year and suspect that sustaining such growth might not be possible for the company. Dell together with CIT had been working on Dell Financial Services (DFS) which had financed about \$2.7 bn in Dell sales in 2002, which contributed to around nine percent of the company's overall value (figures for 2001 and 2000 stood at eight percent and seven percent respectively). Experts opine that Dell may not have any liabilities from DFS, as the venture is not technically a part of Dell; however, it has provided significant contribution to the top line growth of the company over the last few years. The deal structure is such

SPE – The Motives and Methods

A Special Purpose Entity (SPE) is usually floated to perform a specific task(s). These entities because of their asset/liability structure and legal status, which make their obligations secure even if the parent company goes bankrupt, need not necessarily be consolidated with the accounts of their sponsoring companies, provided the third party investor or creditor holds at least three percent stake in such entities as well as enjoys controlling voting rights. These entities' operations are limited to the acquisition and financing of specific assets. The SPE issues debt and/or equity instruments to investors representing claims on the cash flows or assets isolated in that entity.

The asset/liability structure of an SPE can be a "cash flow" or a synthetic one. In a cash flow-based securitization, the ownership of the assets whose cash flows are to be securitized are actually transferred to the SPE. In a synthetic securitization, by contrast, the cash flows and/or economic exposure is transferred to the SPE through the use of a total return swap or some other derivatives transaction. The two are equivalent from a risk and return standpoint, but synthetic SPEs do not assume actual ownership of any assets.

Companies use off-balance sheet financing for two primary reasons:

- To make their balance sheets look attractive to potential creditors, in order to get cheaper funding.
- In order to derive greater tax benefits.

How is it done?

- Companies can lease property or equipment instead of buying it.
- They can sell less tangible assets like accounts receivable instead of financing them.
- Companies create a joint venture or charter a special purpose entity with a new, satellite balance sheet onto which selected assets and liabilities can be moved.

that Dell provides DFS with leads and earns fee in lieu of that which it counts as revenue (revenue from such activities amounted to \$70 mn in 2002). While 70 percent of net profits go to Dell and rest to Tyco, any loss from the activity has to be borne by Tyco. Though Dell, in its filing with SEC has said that bringing DFS on its books will not have any material impact on its revenues for FY 2002, nonetheless it does corroborate that if CIT were to face any problem, Dell might have to arrange for replacement of its financing vehicle to compensate up to about one-tenth of its FY 2002 sales, and that is quite substantial. Though Dell's intentions might not be wrong regarding floating off-balance sheet vehicles however, it will be needless to say that such tangled financial structures can easily prove to be a difficult task for a lay investor to grasp with

While it is true that markets have been witness to growing cases of abuse of off-balance sheet accounting in recent times, it will be equally wrong to say that SPEs are structured in such a way so as to

exploit loopholes in the system by companies. There are several instances where SPEs have facilitated several billion-dollar merger and acquisition deals, one notable example is the acquisition of the global tea major Tetley by Tata Tea, India's second largest tea manufacturer. The deal which was worth 305 Sterling Pounds (approx. Rs. 2000 crore) was completed with the help of a SPE floated by Tata Tea and funded by various outside investors. Experts say that had it not been for SPE, it would not have been easier for Tata Tea to acquire a company several times bigger than it. Formation of special purpose vehicle by Tata Tea ensured that potential risks arising out of financial liabilities remain limited for the Indian tea major retaining although complete control over the British company. There are several such examples where SPEs have proved to be quite useful for the parent company. Industries like airlines and financial services providers have been the major beneficiaries of this financial vehicle in

SPECIAL PURPOSE ENTITIES

keeping undue risks away. Airlines companies use this route (off-balance sheet) to help finance the purchase of planes, others such as financial services firms use it to fund high-risk areas like credit card debts as well as reduce their capital requirements. Pharmaceutical companies float them to create research-and-development joint ventures while several other companies opt for this route so that they could finance real estate through tax-friendly leasing transactions.

The way out

The purpose behind creating SPEs was to enable companies reduce their financial risks—by keeping certain liabilities which were less desirable off their balance sheet. Any company which needed funds to either start a new venture (a petrochemical company needing to build a new pipeline) or augment its resources (an airlines company willing to buy fleet of aircrafts) would float a special purpose vehicle and transfer its liability to this off-balance sheet entity. That way the company would not only derive full benefits from these resources but would also limit its commitment to outside investors or creditors. In theory, it looks like an ideal funding mechanism, but as the experience during the last few years suggests, it is not so.

SPEs which were meant to protect both sides involved in the transaction in case anything goes wrong (promoters' loss is limited to the extent of their investments in the SPE while in case the former goes bankrupt creditors cannot stake claim over SPE's assets), are now increasingly becoming a losing proposition as far as creditors or outside

investors are concerned. Or, so the JP Morgan Chase and Citi Bank's (Enron's creditors) billion dollar losses they are expected to incur in the Enron case suggests. And, it would not be incorrect to say that with changing times, the motif (like tax benefits, risk hedging) behind creation of SPEs by companies, big or small, has changed for the worse. Though SPEs have become ubiquitous and form a part of majority of the funding mechanisms deployed by corporates, they have also come as a handy tool to shrewd executives who have an easy route to perform cosmetic surgeries on their books (as Enron case suggests). The root of the problem (of growing abuse of SPEs), to a major extent, lies in the loophole of the US GAAP. "I think the key hole that needs to be plugged is the outside ownership limit on SPEs. The current requirement of just three percent outside ownership is outrageous," opines Wayman (the three percent rule enabled Enron to keep debt worth \$2.6 bn from three of its partnerships off its balance sheet since outside investors contributed threshold investment of three percent of the overall funding of the partnerships). What the existing regulation does is that it makes it possible for a company not to consolidate its SPE's debts and assets onto its books as long as its holding in the SPE is less than 50 percent of the voting stock. Even more egregious is the fact that what a company needs to do in order to avoid consolidation of its accounts with that of the SPE is to just get an outside investor who needs to hold a mere three percent stake in that SPE. To bring in a sense of discipline among the companies as well as outside investors, Wayman suggests that raising the limit of investment for outside

investors to 10-20 percent could be just what is required. However, fallout of this move could be that a third party would agree to invest in a SPE only when there is increased reward. And, it is most likely that this could make such ventures economically unviable. In case, the sponsoring company is unable to find a third party willing to take additional risk in terms of increased stake and has to

consolidate those off-balance sheet entities with its own account, it would defeat the very purpose of setting up such vehicles; that is to hedge risk. Further, in that case, it is most likely that this could result in sponsoring company's balance sheet look much more complex, that would again be undesirable keeping in mind a lay investor's interests. Besides, not only this would increase the cost of capital of the sponsoring companies, it could also have adverse impacts on their credit rating, thereby making it difficult for them to raise capital from market.

Pointing towards another measure, Wayman suggests that what regulatory bodies are required to do is to ensure the independence of these off-book entities: that is the management of the SPE must not be the same as the company's. "In the Enron case, I find it incredible that Andersen allowed the CFO to be the boss of those SPEs. Clearly this was a conflict of interest that resulted in unjust enrichment of the CFO at the expense of Enron shareholders," says Wayman.

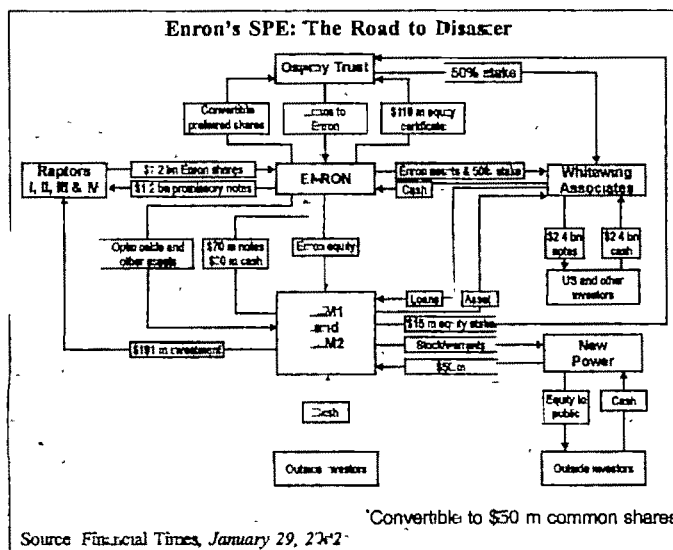
Unfortunately, today SPEs are floated by companies not for the simple motif of isolating risk but to hide material events from investors. As one saw in the case of Enron where it created hundreds of off-balance sheet entities and though it was liable to the extent of credit enhancement guarantee, promises to preserve the investment of outside parties, such risks arising out of potential liabilities was never disclosed in Enron's books, which helped the company in creating a better financial health before the investors. Though it is imperative that level of minimum investment for outside investors must be raised substantially if the SPEs are to be made independent from founding companies, what is desired strongly is that regulators across the globe must ensure that proper mechanism is developed to enforce greater control or apply "stress" control so that company executives restrain themselves from getting into unscrupulous activities. However, one thing must be ensured that such vehicles are used extensively across the wide spectrum of the industry for the purposes that are often legitimate, hence any unmindful change in regulation might affect industries across the board and this should be avoided. ■

Related Article:

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Amit Singh Sisodiya, Team Analyst

Reference # 1-2002-07-04



Stock Index

The ups and downs

After the technology stocks and the K-10 stocks, this year it was the PSU stocks that propelled the stock index upwards. How and to what will the stock index react to in future.

It is said that the movements of the stock market is an indicator of the economic strength of the country. BSE sensx is one of the most prominent stock market indicator. After experiencing high volatility in the past two years the index so far this year is range-bound. The index opened at 3252 and reached a high of 3758 on March 4. The lowest that was recorded this year around 3100 was in May end. The longest sustained rally took place between the 4 and 25 of the May during which the index climbed 400 points. This movement is typical of the index movement, which peaks during the month of February each year. In 2000, the peak was attained on February 3, 2000 at 5925 points. In 2001, the sensx peaked on February 15 at 4435 points. Though the timing of the peak is consistent, the reasons for peaking are different. February 2000 marked the peak of the Internet bubble. The reasons for the surge in stock prices before the 2001 budget and the sharp fall subsequently were attributed to big bull Ketan Parekh.

Though big-ticket operators like Parekh are credited for the movement of the stock index, they are not the sole movers and shakers of the index. The other major factors, which drive the index, are the events that influence the growth of specific industries or an event which affects a specific group of companies like the Government's decision on disinvestments which have propelled the PSU stocks to new highs, for instance.

It is clear by hindsight that nothing has been able to influence the stock markets as much as the Internet boom of the year 2000. The stock index soared to new highs. The index almost reached the 6000-point mark in the month of February 2000. The bull run began in November 1998 when the stock index was around the 2800 mark. The bull run lasted 16 months during which the stock market more than doubled. This has been the longest bull run in the history of the BSE sensx. Once the Internet bubble burst the stock index crashed below the 4000-point mark by May 2000—a loss of 2000 points in a span of three months. This was the time when the smart and lucky made millions and the ignorant ones burnt their fingers severely. Never before were there conditions of such magnitude to make or lose money in the stock markets.

The nightmare returns

Since the burst of the Internet bubble in 2000 the other major movement on the index took place in the following year. During the beginning of the year memories of the 1992 scam came back to haunt the stock markets. This time the prime player was Parekh and his portfolio of stock popularly known as the K-10 stocks. Equity prices cratered when the bear cartel gained an upper hand in the eternal bear-bull tussle in BSE. The trouble started when Parekh stretched himself too thin and the bears started overpowering him. In that period the stock market fell from 4435 on February



brokers policing themselves that highlighted the separation of the management of the stock exchange from the brokers resulting in the demutualization of the stock exchange.

Since the Ketan Parekh episode the stock index is range-bound without any major volatility. Some sector-specific stocks witnessed major movements. Prominent among them were the cement stocks whose share prices soared due to cartels and artificial price fixing mechanism that pegged prices through consent of key players in cement industry. This was due to overcapacity and lack of demand for cement. The news of takeovers in this sector also propped up the prices.

Value searching in PSUs

The PSU stocks have been the cynosure of all eyes so far this year. The perception of the Government taking disinvestments seriously and the increasingly favorable view of disinvestments by all the parties concerned namely the opposition parties and the trade unions lead to a climb in the shares prices of PSUs. Investors who previously saw little value in PSUs, increased exposure to PSU stocks. The fervor reserved for the PSU companies,

Highest Point Touched in the Respective Months				
Year 2002	BSE Sensx	BSE IT	BSE PSU	BSE FMCG
January	3466	1902	1003	941
February	3758	1711	1447	1011
March	3758	1829	1461	1049
April	3538	1786	1700	952
May	3478	1722	1675	907
June	3377	1577	1682	879

14, 2001 to 3550 on March 11, 2001, a fall of nearly 1000 points in less than a month. This scam was an eye-opener and has gone a long way in exposing the cartels in BSE, the broker-promoter nexus, the malady of

STOCK INDEX

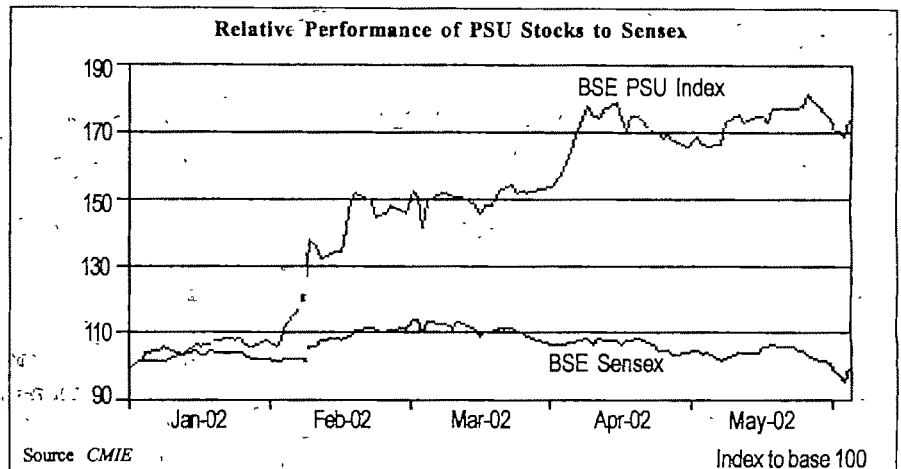
especially the oil stocks, seemed to underscore a point to investors that any price is undervalued. This year's pre-budget peak was due to the PSU stocks soaring on news of disinvestments. The effect can be noticed clearly when one compares the BSE sensx with BSE PSU index. The index, which has the base of 1000 points, opened at 907 points on January 1 of this year. The index soared to 1700 points in the month of April. A staggering climb of nearly 80 percent in less than four months. Compare this with the other sector-specific indices. The BSE FMCG index opened this year at 925 points and reached a peak of 1050 in the month of March. Hardly a movement of 14 percent. Coming to the next popular sector-specific index BSE IT the sensx opened this year at 1612 and reached the peak of 1820 in the month of March. A miniscule rise of 12 percent.

So has the market factored in all the information or is there still some value buying left? According to Prakash Gaba, Technical Analyst at www.prakashgaba.com, "all information available to the market is duly factored in and discounted in the price of the stock. To me the PSU stock in the sensx has rather reached the end of the road except perhaps MTNL, which still seems to have some steam left."

While another technical analyst says that the process has just begun, Balu Bhai, Technical Analyst at www.balubhai.com says, "There is still scope. The process has just begun and expected to continue for quite sometime into the future."

The next big thing

So what would be the next big thing that would move the index the next time? Would it be the operators, a scam, even a or any sector-specific growth? A look at the composition of the BSE index shows that it has three technology firms, Infosys Technologies, Satyam Computers and HCL Technologies comprising roughly 16 percent of sensx weightage as on May 1, 2002. The index has four pharma companies—Dr. Reddy Labs, Glaxo India Limited, Ranbaxy Labs and Cipla—contributing roughly to a weightage of 10 percent. The index has four PSUs—State Bank, MTNL, HPCL and BHEL—whose aggregate weightage comes to 13 percent. The other important and a potential driver might be a market overhang of the recent obsession of MNCs to buyback and delist from the stock exchanges. There are six MNCs on the BSE 30-index—Hindustan Lever Limited (65 percent foreign holdings),



ITC Limited (49 percent foreign holdings), Nestlé (62 percent foreign holdings), Castrol (72 percent foreign holdings), Colgate-Palmolive (54 percent foreign holdings) and Glaxo Limited (22 percent foreign holdings). The combined weight of these companies on the BSE sensx adds up to 27 percent out of which the bulwark HLL weighs in about 16 percent of the sensx.

This at a time when the analysts think that the potential or sustenance of growth levels by HLL is highly unlikely. Balu Bhai says, "It is not right in my opinion to accord HLL the same weightage in the index as in the past. There is a constant need to upgrade/alter the sensx composition itself. We did not hear about BPCL or HPCL or Engineers India and so many other popular stocks till the recent past. Reliance volumes have dropped over the years and so has Hindustan Lever. When such is the case it is not so important to discuss HLL and its role in the coming years in the composition of sensx. I would prefer a monthly differential sensx based on wider parameters and not fixed and rotational indicators which have not undergone much change in the years. How many of us are trading in SBI, Reliance, Hindustan Lever and other so called big movers of sensx?"

With the PSU fever coming to an end and sectors like FMCG and technology relatively stable and the motor vehicle companies like Bajaj Auto, Hero Honda and TELCO receiving their due in the recent past it is highly unlikely of any major surprises springing up this year, unless the MNCs think of buy-backs and delisting. This would again renew the interest of the investors in the MNCs.

Balu Bhai opines that the next push might just come from the tech stocks at

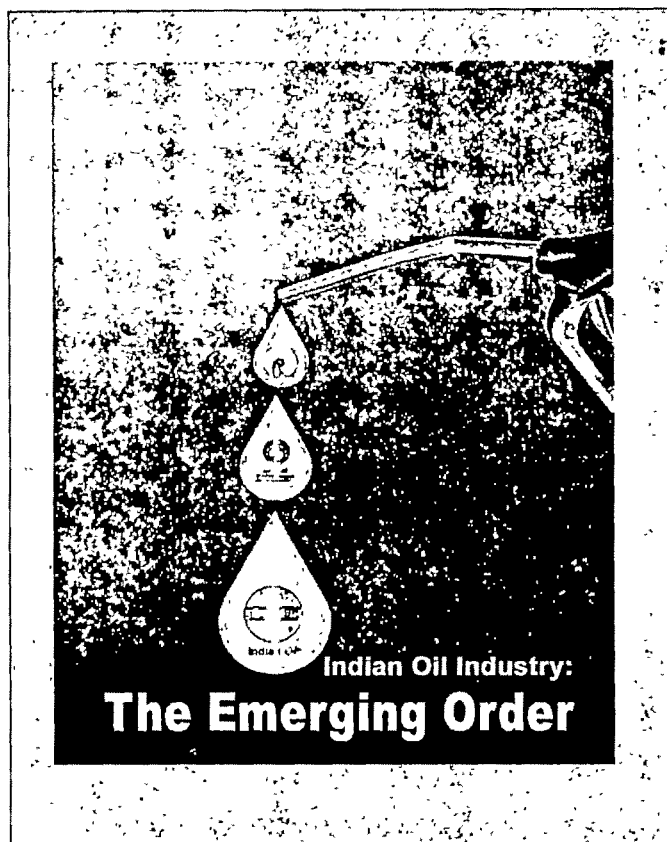
least in the long run. "The tech stocks have a very bright future ahead. They will remain in sharp focus in the coming years. The NASSCOM targets for 2008 is around \$55 bn in IT exports. Even then it is a very small percentage of global IT activity. IT related stocks will and can never go out of fancy. One would be well advised to build a small portfolio of only IT stocks and start buying everytime there is a fall. The sum total of paid equity of all major IT companies in India today would probably be much less than Rs. 500 crore. These are the companies that are going to manage and earn export income of over Rs. 260,000 crore in a few years down the line."

The sensx this year is expected to be range-bound shorn of the volatility experienced in the previous couple of years. Throwing light on precisely what this means, Prakash Gaba says "Sensx construction is a complex procedure and it depends upon the components of the sensx and the way the sensx is arrived at. The undercurrent is still strong and a good technical support exists around 3100 levels. This 3100 is an important level to deal with. The sensx is in positive territory as long as it manages to stay above 3100 levels and I am looking at a level of not more than 3550-3600 levels in the near future if 3100 holds, but if 3100 breaks then the sensx would have traveled to the negative territory and it may go down further to 2800 levels and may even test 2600 levels." But at least for the present moment it is waiting time, where things are stable, till another wave pushes the sensx up or down. ■

D. Sātish, Team Analyst

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Indian Oil Industry: The Emerging Order



With the dismantling of APM (Administered Price Mechanism) and deregulation of the marketing and refining sectors, the Indian oil industry has finally opened itself completely to market forces. This would result in increased private and foreign participation. Players with multiple skills and varying capacities are going to reshape the oil industry landscape by redefining the rules of the game. The emerging order will challenge the abilities of the incumbent players and provide ample opportunities for new entrants. Who will emerge as the winner will be determined only after the new market structure fully shapes up.

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Finally, the much talked about deregulation of the Indian oil industry has materialized with the government dismantling its three-decade-old Administered Pricing Mechanism (APM). This meant the opening of doors for private and foreign players. The three-phased multi-year transformation was hanging in air till the government formally announced its intentions of sticking to the schedule of April 1, 2002. This marks a new era in the Indian oil industry. The decision to dismantle the APM has received appreciation from domestic as well as international industry players.

For the government, opening up of the sector was a real challenge because of the widespread socio-political and economic implications. For the potential players, opening up of the sector meant more opportunities and initiatives to make it big in this low margin, high volume business. Though the demand for petroleum products has witnessed a downturn in the recent times, future projections indicate a strong growth potential. Eyeing the opening up of the sector are big names like Reliance Petroleum Industries, Oil and Natural Gas Corporation, Essar Oil and Shell. Many more international players are observing the sector closely.

Regulation to deregulation

Tracing the history of the industry since Independence indicates that the sector has remained in the strong hold of the government for almost three decades. Though in the initial years of Independence the sector was open, the government nationalized Indian arms of international oil majors—Caltex, Esso and Burmah Shell in early 1970s. The oil crisis of 1970s triggered the nationalization of oil companies. The government nationalized the refining and marketing sectors and subsequently introduced regulatory controls on production, imports, distribution and pricing of crude oil and petroleum products by appointing the Oil Coordination Committee (OCC). Through the committee, the government administered the prices of petroleum products after establishing a complex system of oil pool account. The APM and OCC superseded the role of market through command and control. Through

APM producers, refiners and marketers were compensated for operating costs and were also assured of a fair return on their assets. Prices of the petroleum products at all refineries and locations were equalized utilizing common accounts. This process enabled the development of infrastructure on a massive scale by underwriting investment risk.

After the initial efforts to stabilize prices of the petroleum products across the country, the emphasis shifted to exploration and production. The impetus came in the late 1980s and gained further momentum with the economic liberalization policies. Realizing the importance of investment and private participation in the sector's development, the government opted to deregulate the sector in 1995. An Oil Industry Restructuring Group (R-Group) was constituted in 1995 to develop a road map to open the sector. The R-Group envisaged a three-phased deregulation program. During phase I (1996-98), rationalization of retention margin for refineries, deregulation of natural gas pricing, decanalization of furnace oil and bitumen and partial deregulation of the marketing sector were emphasized. Along with them, the R-Group also advised the government to provide adequate freedom to appoint dealers and distributors, removal of subsidy on High Speed Diesel (HSD) and a gradual reduction of subsidies on kerosene, LPG and input for fertilizers.

During the second phase (1998-2000), the government went ahead with implementing the pricing of indigenous crude on the basis of average F.O.B price of imported crude, rationalization of royalty and cess (taxes), further opening of the marketing

sector and another round of reduction in subsidies pertaining to kerosene, LPG and input for fertilizers. During the final phase (2000-2002), complete deregulation of the sector was to be achieved including Aero Turbine Fuel (ATF), HSD and Motor Spirit (MS) and a transfer of subsidies extended to PDS kerosene and domestic LPG to the general budget. Most of the recommendations of the group were agreed and implemented as scheduled.

Though the industry was opened as per the schedule, there was a long debate

"More competition at the retail level will not result in any real choice in terms of prices, but the players could offer more services at the petrol pumps in order to woo customers."

*Vandana Hari, Asia Oil
News Manager, Platts*

about the opening of the sector. While the political parties tried to intervene time and again, the general public was optimistic about the future scenario. Some believed that the government should control the sector in the best interests of the end-users, economists favored the deregulation citing the implications of burgeoning oil pool deficit on the economy and exchequer. However, the government at the right time realized the importance of deregulating the sector, as it requires huge investments to the tune of Rs. 1,20,000 crore to meet the future demand. According to a forecast by Tata Energy Research Institute, the consumption of petroleum is estimated to increase from 97 MMT to 104 MMT by 2002 and grow at six percent and above. To meet this rising demand the government requires massive foreign exchange reserves since this demand can only be met through imports. The government realized that if the sector is opened and private participation in exploration and production is stressed upon the dependence on oil imports can be reduced drastically. Under the APM model, the government was unable to pass on the increased burden to the consumers. This has resulted in escalating oil pool deficit to unmanageable magnitudes.

Though APM was dismantled, there are some more issues that the government should address. Primarily the issues are regarding the regulator and the role it has to play in future, the implications for the consumers and how it intends to ensure a level-playing field among the incumbents and new players. Until these issues are properly addressed, it may not be possible to envision a deregulated sector in the right sense. Madan B Lal, Chairman and Managing

The government at the right time realized the importance of deregulating the sector, as it requires huge investments to meet the future demand

Director, Hindustan Petroleum Corporation Limited, feels, "In a deregulated scenario, the industry is going to be more competitive, more responsive and consequently more efficient." However, Vandana Hari, Asia Oil News Manager, Platts ("Global energy information provider"), says, "It's early days still and there seems to be a wait-and-watch attitude." Echoing a similar view, Madhu Nainan, Editor - India, *Petrowatch*, comments, "It is still too early to take a view on the deregulated scenario of the downstream sector. Basically for two reasons: First, and perhaps the most important, the downstream oil sector is not as fully deregulated as, say steel or cement. Second, the government has to appoint a regulator for the downstream sector as soon as controls are lifted. We have yet to see that happen."

One of the primary objectives in deregulation was the creation of a vibrant industry that will meet the Hydrocarbon Vision 2025 plans (a blueprint drawn by the government for the Oil Industry). To the extent the government delays the process of removing all controls, most of the intentions are going to remain political promises. Vandana Hari, comments, "The main liberalization is in India's downstream sector, but given the prolonged slump in the refining industry globally, and a continuing squeeze on margins, I don't see new players jumping into India's retail sector anytime soon, certainly not from overseas. The Indian firms that have just received marketing rights but have no products to sell of their own would also remain sidelined for now." This means that the market will be indirectly controlled by the government through its public sector undertakings like IOC, BPCL, HPCL and ONGC. Nainan, exemplifying the situation says, "The downstream sector became fully deregulated on April 1, 2002 and from this day on, oil companies were free to set domestic petroleum product prices in relation to global crude oil prices. But has that really happened? The evidence is there before all of us. It is not the oil companies but oil minister Ram Naik who decides when and by what percentage prices ought to be raised or lowered. This makes a mockery of the whole deregulation."

In fact, owing to the delay in the appointment of a market regulator, the government is looking after issues like price revisions, licensing the new entrants and allocating the exploration and production blocks. Though there is a delay in appointing a regulatory commission, the new entrants are hopeful of changing the market structure, providing competition to the existing players and changing the outlook for the industry as a whole.

Reshaping the industry

Government controlled entities account for 90 percent of the market. Big players like Indian Oil Corporation, Bharat Petrochemicals Limited and Hindustan Petrochemicals Limited dominate the market in the downstream sector, while on the other hand, upstream sector is dominated by ONGC and Oil India with around 84 percent market share. While this is the market in the APM era, the deregulated industry is going to witness a change as the newcomers venture and establish themselves. With the opening up of the upstream sector two years ago, there are a handful of government and private players. The scenario is likely to be replicated in the downstream sector. Although only four players are given the license to market their products in the initial phase the number of players are

The exact time at which the new players are going to enter the market is not easy to predict but taking into account the intentions of Reliance and ONGC, it may not be too far away

going to increase with time. It may not be long before further licenses will be issued to international companies. In future, the market is going to have at least two to three government owned entities along with a dozen of private and international players. Lal, opines, "What is sure is that the number of players will change as private sector players enter the market and companies take up the route of mergers and alliances."

According to Nainan, "The biggest player as of now is Indian Oil, which has the largest refining capacity and the largest share of the petroleum products market. Bharat and Hindustan Petroleum follow. These are the existing players in the downstream marketing of petroleum products. The most important newcomer to watch is Reliance Industries with its 27 million tonnes per annum refinery at Jamnagar and very ambitious plans to set up a retail network across the country."

"The government announced its intentions to sell off Bharat Petroleum and Hindustan Petroleum. ...Reliance is widely expected to buy up one. Why? Because it desperately needs a readymade marketing network that either of them will bring."

Madhu Nainan, Editor - India, Petrowatch

With new players the market is no doubt going to be crowded. It may perhaps take a year or two for the new players to enter the market and reshape the market. The faster they venture into the market the better it is going to be. According to some industry experts, the exact time at which the new players are going to enter the market is not easy to predict but taking into account the intentions of Reliance and ONGC, it may not be too far away.

Commenting about the future market structure of the industry, Hari maintains, "If and when new players come in at the retail level, one could see a temporary crowding of the market, but ultimately this would shake out to leave a handful of robust players." But how the structure of the market will change remains to be seen. Are the government owned entities going to dominate or will it be the new players? Nainan, says, "In a fully deregulated scenario there will be a handful of big players given the very nature of the sector. For any player to survive it is essential to have a strong, widespread, integrated marketing network. Having a refinery is not all that essential as refining margins are going down worldwide." On similar lines, Lal, feels, "The situation in the oil industry is highly fluid. Companies are seeking vertical and horizontal integration, mergers and acquisitions. The industry has undergone some degree of consolidation with the merger/acquisition of pure refiners with integrated companies and with the disinvestments of IBP, disinvestments of HPCL and BPCL are also on the anvil."

It is precisely for this reason that players like Reliance Petroleum and Essar Oil are looking forward to the disinvestments of BPCL and HPCL. Through these disinvestments, they hope to acquire an existing retail chain and

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enter the market with the earliest possible opportunity. Nainan opines, "The government announced its intentions to sell off Bharat Petroleum and Hindustan Petroleum. Of these two companies, Reliance is widely expected to buy up one. Why? Because it desperately needs a ready-made marketing network that either of them will bring." However, both RPL and Essar Oil are not sure about the privatization program and are doubtful as to when it will happen. The future activity is dependent on the disinvestments program of the government, though it has announced its plans of BPCL and HPCL disinvestments.

Competition unlimited

In the initial one or two years the sector is bound to remain under the strong control of market leader IOC. However, once the new entrants establish a retail network and market their products, the competition in the sector is going to rise. Since the sector at present consists of only three players and that too government owned entities, the competition in the sector is very limited. While the new entrants are hopeful about competing head-on with the public sector giants, public sector companies are gearing up for the competition by improving their efficiency and customer focus.

IOC has realized the future competition and its chairman in a recent press meet announced the company's strategy to overcome competition. Though the oil major enjoys a formidable market share of 80 percent, it has its own fears regarding the future competitive scenario. Both BPCL and HPCL have started to enhance their market share by aggressive marketing. In the upstream sector, with the deregulation the heat is already being felt. Both ONGC and Oil India, which have a virtual monopoly situation are competing with private players. Opines Megha Shukla, Area Convener, Oil and Gas, Tata Energy Research Institute, "With the launch of new exploration and licensing policy, there have been some positive responses from the private players also. But there is still a need to provide fiscal incentives in order to attract private investments in E&P business." Once the private players actively involve themselves in E&P business and the

downstream sector also gets deregulated in true sense the dominance of PSU companies is bound to come down.

The real competition will be witnessed in the sector once the private players enter retail marketing. The rules of the game are expected to change dramatically and the pace of competition will pick up with the privatization of HPCL and BPCL. Already both HPCL and BPCL are trying to woo the customers by offering varied services. According to Hari, "More competition at the retail level will not necessarily result in any real choice in terms of prices, but the players could offer more and more additional services at the petrol pumps in order to woo customers, such as bank ATMs, mini-marts/restaurants, telephone/fax facilities, public conveniences and so on. One could also expect loyalty schemes, whereby the customer gets rewarded for patronizing a particular retail chain."

Competition will also squeeze profit margins and sometimes companies might also go for undercutting the prices of their products. However, Hari, believes, "Even in a fully deregulated market, oil companies are unlikely to undercut each other at the retail level at the expense of their margins. And given similar refining facilities, raw material and

distribution costs etc., their production costs too will be similar." According to an industry analyst, the retail prices could differ by one to two percent from company to company post APM. And at times these companies will attempt to undercut each other. In the APM era, oil PSUs were forced to maintain a similar price for the petroleum products. In the

absence of government control oil companies are free to decide and fix prices of their products. Depending on the fluctuations in international prices the companies will decide on how much to price and protect their margins. Opines Lal, "Oil companies have developed strategies to source their crude from the most cost-effective sources, changing their production slates to get maximum value-added products using supply chain management and other tools to achieve cost optimization all along the value chain."

From the customer's point of view, high competition will help in more than one way. According to Nainan,

"What is sure is that the number of players will change as private sector players enter the market and companies take up the route of mergers and alliances."

Madan B Lal, Chairman and Managing Director, Hindustan Petroleum Corporation Limited

"Certainly all this competition (assuming that there will be fair competition and no cartelization) will be to the advantage of the customer, who was so far taken for granted." He further adds, "The consumer is going to benefit in terms of quality of products, variety of choice and service." Says Lal referring to what drives the companies in the free market, "As a result of the competition that is going to come, concerns of the consumers will be the primary objective of the companies as they seek to retain or enhance market share." On the price front, the customer has to adjust to the fluctuations in the prices. Hari comments, "The consumer can expect more transparency in petroleum products pricing. But with the government subsidies gone, he will also have to bear the brunt of the price swings in the international market." Though in the initial few months of the transition, the government and the oil companies ensured the consumer of stable prices, depending on the global price movements the prices may change on a fortnightly basis. In case of extreme volatility in the prices, the consumer may come across varied prices even on a daily basis. However, the oil ministry assures that in cases of extreme volatilities of global crude prices, it would opt for a change in the excise duties to curb the volatility is a soothing factor.

In spite of the licenses being granted to new players, the competition is going to be more only after two years or so. The existing players enjoy competitive edge over the new entrants. Referring to the competitive position of market leader IOC in this regard, Nainan comments, "Indian Oil has the advantage of a well knit infrastructure and network but, being a government company, is slow on its feet. On the other, Reliance is an infant in the business but is quick on its feet."

While the new entrants are hopeful about competing head-on with the public sector giants, these companies are now gearing up for the competition.

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An Economist's Viewpoint

Oil sector deregulation has progressed at a faster pace compared to some other industries like cement in the country. Across the spectrum from upstream to downstream, the sector has achieved near-full decontrol in less than six years. It is a complex process and there are still some areas where action is required. But, by and large, this is a laudable feat, especially given the pace of reforms in other sectors like power.

It is a bit early to judge the deregulated scenario. Once the new pricing system takes firm roots and market-driven prices begin to rule, it would begin sending signals to oil companies as well as consumers to adjust their decisions. For the existing players, the days of assured margins are over. For the consumers also, the certainty of stable, often subsidized, prices are coming to an end. Thus, removal of artificial price distortions would pave the way for investors to take clear decisions about putting their money at various stages from exploration to refining through marketing. Removal of other entry barriers in exploration, refining, transportation, and partly on marketing, including those on foreign players, would increase competition.

In due course, these changes would improve productivity, enhance efficiency of distribution, rationalize the usage patterns and attract more investments across the sector. One could hope that this vital segment of Indian economy would be reorganized more efficiently and benefit consumers.

The oil sector is set to reorganize under the New Hydrocarbon Policy of India, which takes into account various aspects on this crucial energy sector. First, India has low and saturated oil production. Second, productivity levels are low at both mining and refining levels. Third, there is a heavy dependency on imports to meet the gap between domestic supply and demand. Four, natural gas is emerging as a better substitute. Five, India has invested heavily in refining capacity. Six, pipelines are being developed for both oil and gas transportation. Seven, about five products (petrol, high-speed diesel, jet fuel, kerosene and LPG) account for 70 percent of consumption volume. Last but not the least, government controls on production, transportation, distribution and pricing should end completely.

The new market structure would evolve around these parameters. In terms of national security, it is sensible to invest in increasing domestic supplies to avoid a total dependence on imports. It could be better achieved by raising productivity levels or 'recovery rates'. To this end, the government has thrown open exploration and awarded 25 blocks in January 2000. Leading domestic and foreign players like ONGC, Reliance, Niko Resources of Canada, Cairn Energy of Britain, Mosbacher of the US, Gazprom of Russia and Geopetrol of France have come in. TotalFinaElf—another world giant has also shown interest. Being capital intensive in nature, the upstream sector would end up as an oligopoly in keeping with the global trends.

Given the speed at which the private players move and take decisions this competitive advantage of IOC and other players may no longer be a comforting factor. If the opening up of the sector meant more opportunities for new entrants, then it implies challenges for the existing players. It takes a lot of effort and initiative on the part of the companies to succeed in the new competitive market.

Success factors

Like any other industry, the oil industry is associated closely with some crucial factors of success. While in the upstream sector, the ability of the company to identify and develop the oil fields is crucial, in the downstream sector, marketing and brand building, pricing and risk management will decide the success. As of now, no company in India has been proactive on these fronts. But with the dismantling of APM, oil companies are forced to address these vital aspects. Though BPCL and HPCL have been aggressive on the marketing front, not much progress is made on the

other two aspects. Partially this is because oil companies have been operating in a controlled state of affairs where there are no decision-taking powers for the companies. All the aspects regarding the pricing and risk management were absent in APM regime. However, with APM no longer existing, the oil companies have to rethink their strategies in general and take the necessary initiatives. According to Hari, "Even given that IOC, ONGC and GAIL remain under government control, they will have to think and act like private companies in order to compete with the private sector."

Another key element is the ability of the companies to protect themselves from highly volatile international crude prices. In the developed countries, oil companies have separate energy trading departments that monitor the international prices on a day-to-day basis and insulate the company from price fluctuations. Moreover, the marketing risks were also nil for the oil PSUs as fixed margins were provided under APM.

Today, they have to deal with risks including price risk for crude oil, refining margins and foreign exchange risks. According to Hari, "The Indian companies have a lot to learn, including risk management and hedging in the futures market. For this they could look at models and examples of oil companies in some long-deregulated markets abroad." Assured returns no longer exist and companies need to adopt global risk management practices to protect their margins. Shukla indicates the importance of hedging in the refining sector, when she says, "In the refining sector, till now the returns on investments were guaranteed. But the major oil PSUs will have to devise efficient mechanisms to procure crude and hedge risk in order to handle the volatility in crude prices and a deregulated scenario." Private and international players are far ahead of oil PSUs, as they have the risk management teams in place.

On an equal front, marketing and branding of petroleum products assumes greater importance. Shukla opines, "In a

The downstream sector seems to be heading for a rather narrow oligopoly. In the refining sector, the government policy is forcing the public sector giants to face formidable domestic private players. Reliance's IPCL acquisition is a case in point. Already more refining capacity has been announced to take care of demand at least till 2005. Thus, there are going to be very few (but more than two) players in this area. Already, government has dismantled APM and disbanded the Oil Coordination Committee. Though some intervention exists in the initial stage, the prices of all oil products will be dictated by global trends in near future. This has also ended the era of guaranteed margins and firms would have to design their own policies and strategies for survival.

Consequent to deregulation, there is a lot of investment made in the intermediate segments like transportation, distribution and marketing. While transportation and distribution network may follow the footsteps of the refining segment, marketing promises to be keenly competitive. Presently the entry of foreign players is limited. The domestic companies are expected to streamline their marketing and distribution networks in the intervening period. But, the competition would really hot up when this last segment is fully globalized.

Post-deregulation, the oil industry is attracting large investments, not only in exploration and refining but also on distribution infrastructure. These developments would create a large number of jobs and incomes for the people. The economy would also benefit from more efficient utilization of scarce resources. Oil being a key source of energy, its market-based pricing would help superior allocation of investible resources. It would also help industrial sector by removing artificial distortions and investments based on that. Illustratively, decisions such as to invest in diesel or petrol technology will no longer be dictated by distorted pricing based on political consideration. It would also encourage usage of cleaner fuel and conservation.

Consumers would have to come to terms with market-based pricing. Here again we are talking about a critical energy product whose demand, by definition, would have low price elasticity. Initially, as we are already witnessing, there would be more adverse shocks like steep and upward price revisions. These are unavoidable as we move from a highly controlled regime to a market-oriented one. Initially, the price revisions would also take up the burden of dismantling subsidies. But over medium- to long-term, the consumer would be required to pay prices of oil products dictated by global industry trends.

Going by the past experience, oil industry is highly cyclical. Although, the collusive pricing power of the OPEC cartel has considerably weakened over the past couple of decades, the industry is highly sensitive to events like war, causing production and supply disruptions. On the flip side, the Indian consumers would benefit from future technological breakthroughs and other positive developments much faster than ever before. The regime of assured fat margins is over and competition would ensure marginal cost-based pricing.

—R P Purohit, *Economist, Hindustan Construction Company, Mumbai*

deregulated market, a good marketing network is next only to an aggressive pricing strategy." It would be difficult for the PSUs to continue their virtual monopoly. Commenting on the importance of marketing in oil industry, Nainan says, "Marketing will play a very key role in the retail sector as IOC fights to retain its market share and Reliance, Essar and other new players try to either poach into its territory or at least limit its growth. All players will have to focus largely on brand building and marketing to grow in the market place." No doubt, marketing will play a vital role in the success of the oil companies as the competition intensifies. This is particularly true for an industry which has negligible product differentiation. To be a successful marketer of oil products, companies need to identify the right propositions. Feels

Lal, "Marketing will have to encompass the entire value chain from cost control to product life-cycle, positioning, brand building, pricing, credit control and man management."

One of the better means to market the products is to price them near the customer. Though most of the companies are not sure about their future pricing strategies, they are working on arriving at the right strategy. Hari says, "There could be some price competition among the companies, but significant differences are unlikely in the retail prices charged by the various oil companies." Though it is only an assumption that oil companies will price their products competitively, in reality, they will not try to squeeze their margins further as they are already under strain. Opines Nainan, "For mass consumption products such as petrol,

diesel, LPG and kerosene, pricing will be more or less uniform between the various competing companies, leaving negligible scope for working out any significant strategies."

However, companies have more choice in terms of industrial consumers. Though IOC has well established relations with the industrial consumers like Indian Railways, others are raising the marketing pitch in this sector too. Both BPCL and HPCL are trying to improve their industrial marketing also. According to Hari, "There could be more competition in supplying to industrial consumers and there the prices may vary depending on volume discounts, terms or supplies and relationships between the companies." In this segment the competition is likely to be more, as cheaper import alternatives are available to the consumers. Suggesting an alternative approach, Nainan says, "For industrial and commercial use products, a sure-footed and numble pricing strategy is a must to capture and retain consumers. To emphasize, pricing strategies will be a

One of the better means to market the products is to price them near the customer

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valuable marketing tool for certain segments in the sector."

Not only is the pricing of the products important for the oil companies but also developing the brand name by means of different promotional activities. To cope with such a scenario, oil companies need to be more aggressive in expanding the retail chains and attempt to build a strong brand image. Lal opines, "As the market becomes competitive, brand management will require careful thought. Though differentiation remains the key to competitive advantage, it may no longer serve the purpose. What will be required is a bundle of products and services, a bundle called convenience. This has to be delivered through the channel that is most appropriate, which may be different for different segments of the consumer population." Shukla exemplifies, "The players will have to offer bonus/incentives to customers. Innovative marketing strategies will have to be offered such as: a) TotalFinaElf offers watches worth Rs 200 with every 20-liter can of diesel engine oil; b) Indiar Oil Corporation, on the other hand, recently tied-up with United India Insurance to offer personal accident cover to Servo lubricant buyers in West Bengal; c) BPCL also ran a Sona-Chandi scheme aimed at diesel engine users mainly truck drivers."

During the APM regime, the companies never thought about building a brand and loyalty. Since the three oil PSUs shared the market, the need for building brands was never felt. However, deregulation of the industry has made this a significant determinant of success. Commenting on the need for brand building, Nainan says, "With deregulation and entry of new players as well as greater choice available to the consumers, brand building has suddenly become important. Look at the way petrol pumps have been spruced and jazzed up several petroleum loyalty programs in the market." The brand building campaign of BPCL (Pure for Sure) indicates the present scenario. This is going to be more important as and when new entrants start selling their products. In future, one can see more brand promotion programs taken up by the companies. For Reliance, establishing a brand image for its

petroleum products may not be a difficult task considering the fact that the brand image of its parent company is well established in the minds of consumers.

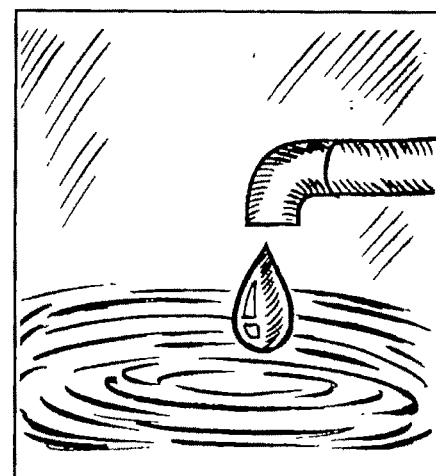
Though the market today is dominated by the oil PSUs with a retail network of more than 18,500 petrol pumps spread across the country, the marketing skills of the oil majors will be put to test by the entry of private players. For the new players the real challenge lies in competing head on with this huge retail network and setting up a similar network. Nainan states, "Certainly the most important factor is a good, extensive and broad network of retail outlets as well as pipelines to supply products. IOC, BPCL and HPCL have these in varying degrees. Reliance and Essar are not blind to these factors and are engaged in setting up these networks." It may well take some time, perhaps two years for the new entrants to set up a retail network.

On the other hand, there is an increasing feeling that with the new players establishing their retail networks and existing players planning to expand their networks, the number of retail outlets will grow by 35-40 percent in the next five years. Players fear that this rapid rise in retail outlets could create the problem of plenty in the industry. Establishing a retail outlet requires the commitment of huge investments. Reliance Petroleum has calculated the cost of setting up one retail outlet to be approximately one crore depending on the locality. Additionally, private players have the expertise in maintaining healthy dealer relationship and perhaps the new entrants will focus on competitive strength. Essentially, the loyalty factor is developed through a dealer and in most cases, dealers shaped or marred the success of a brand or a product.

Not only is the pricing of the products important for the oil companies but also developing the brand name by means of different promotional activities

Regulation

The Indian oil industry has come a long way since 1890. In spite of its century old history, it is plagued with some serious bottlenecks. For the industry to evolve into a vibrant market that can support the economical growth of the country, overcoming these bottlenecks is imperative. Some of the hindrances are partially due to excessive government control earlier.



Though the intentions of the government in liberalizing the sector are good, it has failed on one important ground. In a free market, theoretically speaking, the role of the regulator is minimum. However, during a transition period, a regulator has to be in place to ensure a smooth switch over from regulated to deregulated market. Supporting this Hari says, "By definition, it should be absent in a fully deregulated environment. But it is also widely agreed that some form of guidance is necessary for the industry, especially in a newly liberalized market."

The government as part of its schedule is supposed to appoint a regulator before the deadline. The draft regulatory bill is yet to be approved by the Indian Parliament and till such time the government is taking up the responsibility of the regulator. Questions Nainan; "The Petroleum Regulatory Board Bill provides for setting up a regulatory mechanism for the sector. But till the Bill becomes law who will play umpire? Should the government as a owner of oil companies take the responsibility even till the regulator becomes regulator?"

In the absence of a regulator, the industry is going to be managed and dominated again by the political parties. For instance, the abolition of the dealer board by the government has shifted the responsibility of appointing a dealer to the oil companies. Now the oil companies express fears about political intervention and the direct pressure that political leaders might exert upon them. In fact one of the oil company officials said that only 40 percent of the dealer quota can be appointed by them and the rest are reserved for backward classes, women,

ex-servicemen and disabled. What is the rationale behind abolishing the dealer board when 60 percent is still reserved? Nainan comments, "We still do not have a regulator in the true sense of the term and are unlikely to have one even by the end of the year. All this is to the immense advantage of the political establishment which can use the oil sector as a convenient tool for dispensing patronage." The inability of the PSUs to move swiftly and take decisions is also helping the political circles to exert extra pressure on them. For instance, the PSUs can fix the price of the petroleum products by themselves after April 1, 2002. However, the recent price hike in petroleum products took place only after getting the approval from the government and oil ministry. Even the prices decided by the government were not in line with the crude import parity. This only indicates the extent of damage government has inflicted on the oil PSUs' ability to take decisions.

Another question of increased concern to the oil industry is regarding the role of the regulator in the deregulated environment. The exact scope and duties that are going to be discarded by the regulator are not known and one doubts whether the regulator will have any powers or will simply be a puppet in the hands of the government. Also whether the industry will have only one regulator or separate regulators for downstream and upstream sectors is yet unclear. Lal reveals, "With the deregulation of the industry, market forces should act as regulator in ensuring efficient allocation of resources. In such an environment, primary role of the regulator is to foster competitive conditions and to ensure that the environment and safety standards are adhered to." Hari echoes a similar viewpoint, "The challenge for the government would be to define the role, responsibilities and the authority of the new downstream regulatory board. Fair play among the industry players, protecting consumer rights and safeguarding the environment are some of the aspects the watchdog will need to be alert and responsive to."

Also the government must ensure by means of the regulator, a level-playing field for the players (Government and

Private). Shukla opines, "The regulator will protect the interest of consumers and also at the same time take care that product price variations are justified. Ideally, there should be one regulator for upstream as well as downstream oil sectors. It should be independent of government and would need to interfere in the market amongst players only in case of emergency." For the industry to evolve by its own, it will take a year or so, but this time should be used to clear the misconceptions regarding the role of the government and in planning to meet the future requirements of the country. In the absence of such an effort, the industry is bound to remain in the government control indirectly and will never be able to contribute to the realization of the Hydrocarbon Vision 2025. Unless all the controls (direct and indirect) are removed, the very purpose of deregulation can fail leading to pre-nationalization conditions emerging again.

Future

As the energy demand for the country is on a constant rise, the impetus is on the oil industry to deliver. The deregulation of the upstream sector is starting to yield results with more investments coming into the sector, thanks to the National Exploration Licensing Policy. Similar efforts in the downstream sector will enable the sector to grow robustly. With the dismantling of APM, the burden of subsidies is now being passed on to the government. For the players, their profitability is a semblance of their abilities and strategies. How effectively they integrate with the global markets and compete with each other will decide their degree of success. Hari says, "The bottomline and the main driving force of the

industry will remain in the oil companies profitability. Greater transparency, public accountability and operational efficiencies will occupy center stage as these companies eventually emerge out of the PSU mould. Obviously, with the government disinvesting PSU oil company stakes, the new private or public stakeholders should keep a firm eye on the financial health of the company."

Unless all the controls (direct and indirect) are removed, the very purpose of deregulation can fail leading to pre-nationalization conditions emerging again

"With the dismantling of the APM, private players will also gain a presence in the Indian oil and gas sector and hence there will be competition between the players..."

*Megha Shukla, Area Convener,
Oil and Gas, Tata Energy
Research Institute*

With the projections about the industry growth rates being optimistic, the future outlook for the companies is brighter. Shukla paints a fair picture of the future by saying, "In the deregulated scenario, the Indian oil industry will get exposed to the international market forces. With the dismantling of the APM, private players will also gain a presence in the Indian oil and gas sector and hence there will be competition between the players that will ensure the growth of the sector in the next decade." In the next two years, the industry is going to witness sea changes. Retail networks, logistics management and risk management are going to be the crucial factors. Shukla comments, "The stand-alone refineries will have to be merged with the marketing companies, as they do not have the distribution infrastructure to sell their products in a deregulated market." For those companies with refining capacity, the challenge is to set up the retail chain for marketing their products and for the companies with network, exploration and refining is the challenge.

In spite of all the challenges and bureaucratic hurdles, oil companies need to forge ahead as the stakes are higher in the industry. A new order is going to emerge in this sector as government, private and international players compete in this high capital-intensive market. ■

Related Articles:

1. APM Caught on oily grounds? *Analyst*, May 2002
2. Indian Oil Corporation Acquiring energy, *Analyst*, March 2002
3. Oil Prices Highly inflammable, *Analyst*, October 2000

Y Chandra Sekhar, Team Analyst

Reference # 1-2002-07-06

BUSINESS ENVIRONMENT

Andersen-E&Y

Future perfect?

By taking a big bite of Andersen's consulting practices, E&Y has ensured itself the number two spot in the top league in the global consultancy arena. However, success will not come without clearing hurdles like cultural conflicts, service consistency and compensation disparity.

"From the outset it was clear that Andersen had to go somewhere. It became a competitive issue among the other four global accounting majors as to who would achieve the gains of its people, their clients and their scale of operations."

—Paul J Ostling
Global Executive Partner, E&Y

Does this leave any doubt about what drove Ernst & Young (E&Y) to acquire Andersen's business in some 40 countries? On the prima facie it appears to be a no-nonsense idea. Don't allow the rivals to snatch away a prized catch (it's another matter whether Andersen is actually a prized catch or not).

The revelations about E&Y's intention to acquire Andersen's practices in 40 countries were quite startling, given the fact that its image has taken so much battering in recent times courtesy Enron. (Recently, the US court convicted Andersen as guilty in the high-glare case of Enron's collapse.) Nevertheless, the combination, rather than merger boasts of having a competitive edge over rivals and would pose an insurmountable barrier. However, on the flip side, the merger hardly addresses key concerns such as cultural conflicts, service consistency and compensation disparity.

Changing fortunes

Andersen, once the crème de la crème of accounting firms was knocked to its knees after the implausible news about its role in the collapse of power giant Enron broke out.

Andersen, established by academician Sir Arthur Andersen as Andersen DeLany & Co. started its remarkable journey on December 1, 1913, to become the world's biggest accounting firm. However, no one had expected such a

bitter end to the once bright star of the accountancy world. Andersen has to face its end in the form of mergers and sell offs.

The downward spiral of the consultancy major started long back in 1989 when it had to split from its consulting arm, Andersen Consulting, which toppled it to fifth position from the first position among the Big Five accounting firms. Since then, Andersen's record has been marred by its role in several high profile accounting scandals like Sunbeam and Waste Management, apart from Enron. To settle the Waste Management case, the firm had to pay \$7 mn in June last year. However, it was Andersen's involvement in Enron's collapse that took the shape of the final straw that broke the camel's back. On March 14, the US Justice Department announced its indictment of Andersen for obstruction of justice in the high glare case of Enron.

The judgment came at a time when corporate America was entering the annual meeting season where shareholders approve the independent auditors for the coming year. Companies were worried about the awkward questions raised by shareholders about Andersen. These companies had no option but to change the auditor, though it was time consuming and expensive. The early list of losses for the tainted firm included companies like Merck and Co, FedEx, Delta Airlines and so on.

Added to this, the firm made sumptuous payment to settle the case brought by the shareholders of the tainted power major, Enron. At a meeting with William Lerach, the lead lawyer for the plaintiffs, Andersen proposed to pay \$375 mn-half



it's original offer to settle the claims, but Lerach responded with a demand for five times that amount.

If this was the picture externally, the internal aggression took its shape when Andersen partners individually approached rival firms for prospective merger talks. Paul A Volcker, Chairman, Independent Oversight Board, came out with suggestions to resolve the crisis the beleaguered firm was facing. Volcker came out with three proposals, implementing which was next to impossible. One of the three proposals included formation of a seven-man governing board led by Volcker, which would control the organization globally. This was impractical to implement given that consultancy is a closely guarded profession and procuring information is next to impossible for an outsider. Second being Volcker's demand to cap the legal liabilities, implying a settlement of lawsuits brought by the Enron shareholders; this is a difficult concession to win in the litigious environment in the US. The third demand is for the US Justice Department to dismiss or suspend the indictment of Andersen, which is again impracticable. In this scenario, Andersen had only one option—find a buyer. After

Andersen's record has been marred by its role in several high profile accounting scandals like Sunbeam and Waste Management, apart from Enron

many dramatic turns and twists, Andersen was successful in its annulment. In the race, E&Y got the lion's share acquiring Andersen's operations in 40 countries. Deloitte Touche Tohmatsu bagged 12, KPMG acquired in five countries and PwC in three countries.

Key issues

The E&Y-Andersen combined firm has got a long way to go, filled with stymies and only time will tell whether it will be able to cross all the stymies successfully and reach the goalpost. When it comes to the operational problems, E&Y faces the problem of human resource equity, service consistency and cultural problems. Not only in accounting sector, in any area handling post merger activities is an arduous task. In professional fields like consulting, salary structure is different from the manufacturing organizations. Maintaining uniformity in salary at all levels of the merged entity is an intricate job. Andersen's pay structure is more than double the industry average. The options lying before E&Y to maintain uniformity in salary structure is either to slash the salaries of the Andersen employees or to hike the salaries of the E&Y employees. If it goes for the first option, the depressed Andersen employees may leave the organization and one of the major considerations of the merger, 'the talented pool', will prove to be a misapprehension. On the contrary, if it opts for the second, E&Y has to

face huge expenses in the form of hiked salaries of the E&Y employees and it would hurt the profitability of the firm. In this context, the case of PwC is adducible. When Pricewaterhouse was merged with Coopers and Lybrand, it took one year for the merged entity to bring down parity in salaries of both the companies.

Another issue is that of cultural conflicts. Most of the mergers fail due to such conflicts. Andersen has been from its primordial stages of existence, a somewhat more homogeneous culture, while E&Y has got a different corporate culture. Another important stymie in the path to success is the service consistency. Though Andersen and E&Y offer similar range of services, they differ in niche

Andersen's 2001 Revenues by Area (In US \$ bn)		
	2001	2000
North America	4.49	4.01
Latin America	0.39	0.39
Western Europe	2.87	2.63
Central Europe, Middle East,		
India and America	0.39	0.36
Asia Pacific	1.20	1.12
Total	9.34	8.51

Andersen's 2001 Revenues by Solution (In US \$ bn)		
	2001	2000
Assurance and business advisory	4.26	3.92
Tax, legal and business advisory	2.98	2.62
Business consulting	1.70	1.62
Global corporate finance	0.39	0.36
Total	9.33	8.52

terms. The amalgamation process involves an act of dexterity, which involves functional and cultural overlaps.

Will it be a better tomorrow?

Late in 1950s it was the Big Eight accounting firms and after a series of mergers in 1980s, the number of firms ruling the accounting world was downsized to six and with the merger of Pricewaterhouse with Coopers & Lybrand, it became Big Five and the recent merger between E&Y and Andersen makes it the Final Four.

What do these mergers imply? The decrease in the number of audit firms controlling majority of the consulting industry leads to the concentration of the audit services in the hands of small number of large firms. This could also result in the pooling up of those valuable talents,

which enable the newly merged entity to grab the major portion of the market share. But the big question is: Will it be true in case of the combined entity of Andersen and E&Y? The dexterity of the combined entity would lie in the manner it makes use of the combined talents and deal with the disparities.

The combined firm of E&Y and Andersen would result in a firm with world-class talents in the diversified areas. The major areas of strength of Andersen are assurance, tax, consulting, corporate finance, utilities, power, oil and gas sectors. When merged with E&Y, Andersen would bring with it, this pool of talent along with the diversified client base. The merger will also help improve the position of E&Y globally making it

number two in the big four firms, a notch below PwC but a notch above KPMG.

The fact that Andersen has been one of the top growing firms adds further weight to the merger case. If the revenue structure of the Andersen is considered, the firm has achieved double-digit growth uninterruptedly for 12 out of 13 consecutive years. Geographic area-wise, it recorded a growth in revenues in all the areas it operates (see tables: Andersen's 2001 Revenues by Area and 2001 Revenues by Solution). Overall revenue recorded a growth of 10 percent. Andersen had acquired E&Y's operations in 40 countries concentrated in Europe, Middle East, Russia and Asia. In all these areas, Andersen recorded a dazzling performance. This implies that the combined firm will see a steep rise in the revenues.

Andersen has more than 85,000 people in over 84 countries, united over a single worldwide operating structure that fosters inventiveness, knowledge sharing and a focus on client success. This does suggest that E&Y has taken a right decision by acquiring a 'strong' company. If every thing goes as planned, the merger will be a successful one with the resulting unit enjoying major synergies in key operational areas. Nonetheless, what matters now is the day to day operations of the combined unit, which promises not to be free from hurdles, which arise when it comes to the practicality of the implementation. ■

Related Article.

1. Eruption of Mount Andersen, *Analyst*, April 2002.

Amit Singh Sisodhya
(with inputs from Sharath Jutur)
Team Analysts

BUSINESS ENVIRONMENT

Tobin Tax

The Loch Less monster?

Though the repeated occurrence of financial crises has raised serious questions regarding the practical efficacy of introducing Tobin tax, it continues to be a Loch Less monster for most central bankers and monetarists across the globe.

As long as James Tobin was alive, the tax that goes by his name was theoretically considered worthwhile to be implemented. Over the years it has been proposed in various versions and for a different number of reasons. Economists worldwide have always expressed a mixed reaction regarding the effects of such a tax on international financial markets. Some opine that imposition of such a tax would remove the disparity between the developed and the developing nations while others feel that the financially and economically backward nations would be adversely affected. In the words of James Tobin, "The tax is meant to improve the macroeconomic performance of economies trapped by external financial pressures." However, after his death on March 11, 2002, there have been growing concerns about the efficacy of putting the tax into practice.

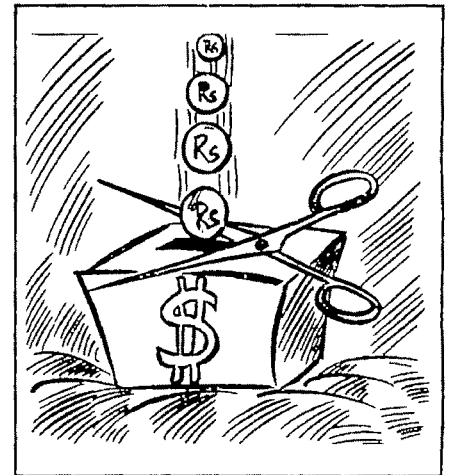
Tobin's idea

Tobin had strongly believed that economics is a science that had the potential of improving the happiness of mankind. In his words, "The unprecedented inequality of wealth, income and wages in America is a crisis threatening the sense of community, the essential foundation of the republic." His groundbreaking works in the area of portfolio selection titled, "Financial Markets and their Relations to Decision, Employment, Production and Prices," fetched him the Nobel Prize in 1981. However, the concept of imposing a tax on foreign exchange (forex) transactions to limit speculation occurred to him way back in 1972. That was when the Bretton Woods system was in turmoil and currency speculation was

widespread. The introduction of computers in foreign exchange transactions made wild speculations all the more easier. Tobin's idea was to introduce an internationally uniform tax on all spot conversions of one currency to another, proportional to the size of the transaction. This, he contemplated, would punish short-term trading more seriously than long-term trading. The greater objective was obviously to make currency exchange rates reflect, to a larger extent, the long-run fundamentals relative to short-range speculations and risks, thereby reducing volatility. The other intention was to preserve and promote the 'autonomy of national macroeconomic and monetary policies'. Though the imposition of such a tax as a major tool to raise revenues for international purposes has become the issue for many of its supporters, Tobin himself never considered it as a major motivating factor for its imposition.

Commenting on the underlying idea of Tobin tax, Ravi Jagannathan, the Chicago Mercantile Exchange Distinguished Professor of Finance and a Faculty, Kellogg School of Management observes, "Tobin's idea was to tax forex transactions that would discourage short-term speculative trading and thereby make currency exchange rates have a bearing on long-term fundamentals—and reduce the short-term volatility of forex rates."

In sharp contrast, Blair Baker, Director, Forex Research, Global Capital Investment Ltd., Wall Street, New York argues, "The tax would be charged without any distinction between speculation and commercial activity. It would in theory decrease speculation by making it more expensive to carry



positions but this would probably create more volatility—not an intended effect."

Ironically, despite being pro-globalization himself, Tobin's suggestion of imposing a 0.2 percent tax on forex transactions was immediately picked up by anti-globalization campaigners. Frustrated Tobin remarked, "I have nothing in common with those anti-globalization rebels.. the loudest applause is coming from the wrong side."

He was rather disappointed and surprised when critics seemed to miss what he regarded as the essential property of the transaction tax—"that this simple, one-parameter tax would automatically penalize short-horizon round trips, while negligibly affecting the incentives for commodity trade and long-term capital investments." Tobin explained that a 0.2 percent tax on a round trip to another currency costs 48 percent a year if transacted every business day, 1 percent if every week and 2.4 percent if every month. But it is a trivial charge on commodity trade or long-term foreign investments. The tax has the ability to handle built-in flexibility problems that are traditionally tackled

Tobin's idea was to introduce an internationally uniform tax on all spot conversions of one currency to another, proportional to the size of the transaction

Tobin Tax - Problems in Implementation

It is widely accepted that there is a significant amount of currency speculation taking place in the financial markets of the world, facilitated by the global nature of the market. The freedom of the global market is intended to encourage world trade by facilitating the free movement of capital. A side effect, however, has been the freedom for short-term speculation, facilitated by free global markets. Such speculation is not of particular concern when it is on a small-scale. However, if and when it becomes a large feature of the financial markets, it evolves into a problem that can interfere with world trade and unduly influence both exchange rates and the domestic economy of a country. For example, in the UK people remember Black Monday when currency speculation resulted in Sterling being forced out of the European exchange rate mechanism, resulting in the resignation of the Chancellor of the Exchequer, and possibly the subsequent failure of the UK to join the European Community single currency (the Euro). At the same time George Soros was able to openly boast of the amount of money he had made from the speculation he engaged in at that time. If this can happen to the UK, then this must be occurring in many smaller countries, which can be subjected to similar blackmail with much more ease.

This raises a number of issues not just for individual countries but more importantly, for the global economy as a whole regarding the extent to which individuals or institutions should be able to unduly influence the activity of the markets for their own benefit. A free market implies something approaching perfect competition in order to function for the benefit of all and undue influence negates the fundamentals of free market. Many companies internally have antitrust legislation of some sort to regulate this kind of behavior. For the global currency market the problem is how to ensure the free movement of capital while discouraging damaging short-term manipulation through speculation. The proposed answer is the Tobin tax and so it becomes important to examine the likely effectiveness of this tax in achieving its objective.

In the first place the tax must be relatively easy to apply and would be effective only if it covers all currency movements. If this is not the case then it will merely result in the movement of funds to exempt areas without achieving any benefit. There is some danger that this could be a result. Secondly the size of the tax must be such as to discourage speculation without discouraging the free movement of capital for facilitating economic activity. This is an impossible objective as the potential gains from speculation are likely to exceed the size of the tax imposed while for normal economic activity the effect is merely to increase the cost of capital. Therefore, the question that arises is whether or not it is possible to discriminate in the imposition of the tax in order to penalize speculative activity. However, this would require impossibly complex regulatory activity, which would in all probability promote economic activity in the area of tax avoidance. Thus it seems unlikely that the tax can be used to meet its objective of discouraging speculative activity.

In this case, therefore, the benefits of this tax need to be considered in terms of the use to which the tax revenue is put. At a global level then any concerted attempt by various countries to act for an agreed objective must be beneficial to the reduction of unilateralist behavior. This is particularly the case when the intention is, as here, a reduction in the concentrated power of global capital. Undoubtedly, the revenue generated by the tax will be substantial and will have the potential to be used to beneficial effect in the amelioration of disadvantage in the global economic environment if utilized correctly. In short the concept of the Tobin tax is well intentioned but not necessarily well conceived in either its implementation or its effects.

— Dr. David Crowther, Director of Research, Business School, University of North London

by rigid quantitative exchange controls or financial regulations.

Market opposition

Despite having a pro-free market and internationalist stand, why the tax has always been treated as a Loch Ness monster by most of the central bankers and financial market intermediaries worldwide, remains an unanswered question.

Probably the inability of most of the central bankers to come out of the vicious circle of monetary policy targeting despite the fast changing exchange rate regimes and financial market openness

explains some of their reluctance. They have been particularly susceptible to monetarist reasoning—only monetary policies with money stock controlling under very tight constraints are capable of avoiding inflationary pressures and maintain sustainable economic growth.

Economists have always strived to enrich the subject by developing untrue and unrealistic assumptions trying to justify their instrumental value for building mathematical and statistical models. However, history proves that economics can explain very little and predict hardly anything at all (see A Sayer, *Method in Social Science: A Realist*

Approach, 1992, pages 178 - 180). The basic reason for Tobin not being accepted is that he went against the basic tenets of economics. He bluntly pointed out that markets are not necessarily efficient and there are no 'rational expectations'. Future parties and prices are largely unpredictable. There are only uncertain and ambiguous estimates. He even discards the possibility of the existence of a unique equilibrium depicted by Pareto Optimality and argues that it is only a theoreticians' fiction. According to him it is only the incalculable real world processes that determine the real prices and parties. Tobin himself was a strong

TOBIN TAX

opponent of the mainstream economics and little wonder that most mainstream economists and central bankers dismissed the proposal for a currency transaction tax.

However, history has proved that merely freely convertible and floating financial markets do not necessarily lead to efficiency gains, enhanced stability and greater economic freedom of nations. It was only the endless stream of financial crises of the 1980s and 1990s around the world that emerged as a growing support for a global currency transaction tax. Following each financial crisis, Tobin tax has confirmed the relative explanatory and analytical power in comparison to that of the monetarists.

The support

When the series of severe monetary difficulties started in small countries like Finland, Norway and Sweden leading to devaluation of their respective currencies in 1987, nobody recalled Tobin tax. Later in 1992, the speculative runs virtually demolished the EMU's Exchange Rate Mechanism. This turmoil was quickly followed by the Mexican crisis in 1994 when the Mexican peso fell by more than 30 percent. Soon after, in 1995 the Mexican disease percolated across the German DM and the Japanese Yen. This was then followed by the severity of the Asian crisis followed by the collapse of Russia. In 1998, the speculative activities in many of these countries virtually emptied their reserves. Though the speculators were eventually bailed out, economies were in a severe recession. People feared whether Brazil would go the Russia way. As opposed to Russia, Brazil was a much bigger factor to the world economy and had the potential to trigger a severe recession in the whole of Latin America. At that point, the future continued to remain uncertain in Asia, Russia and Latin America.

By that time it became crystal clear that it is the volatility and increasing magnitude of global financial markets that were causing universal feeling of insecurity. Gradually a counteracting force against the traditional monetarist principles and supporting the levying of a tax on currency transactions became vocal. The ATTAC (Association pour une Taxe sur

How Tobin-style Taxes Would Work

- Currency speculators trade over \$1.8 tn dollars each day across borders. The market is huge, and volatile.
- Each trade would be taxed at 0.1 to 0.25 percent of volume (about 10 to 25 cents per hundred dollars).
- This would discourage short-term currency trades, about 90 percent speculative, but leave long-term productive investments intact.
- The currency market would thus shrink in volume, helping to restore national economic autonomy. Nations again could intervene effectively to protect their own currency from devaluation and financial crisis.
- Billions in revenue, estimated at \$100 bn-\$300 bn per year, would be generated.
- Revenue could go into earmarked trust funds to fund urgent international priorities.

Source: Tobin Tax Initiative, California, US

les Transactions financières pour l'Aide aux Citoyens) was founded in June 1998 with more than 6000 members in France and quickly became a center of a transnational network. Gradually, associations were formed in Brazil, Canada, Switzerland, Australia, France, New Zealand, Sweden and other places. The growing list indicated the emerging political momentum for the Tobin tax. Political parties from more than 25 countries came forward supporting the tax. Soon the imposition of the Tobin tax was listed in the global economic agenda in the turn of the century.

Despite these developments, relative ignorance and attachment to traditionalism continued to act as deterring factors to the imposition of the tax.

There were essentially two arguments against its implementation. First, the orthodox economic theory—free markets are optimally efficient and the presence of an automatic adjustment mechanism. Second, it is impossible to implement such a tax because of the tax evasion problem and the lack of adequate political support.

Jagannathan brings out yet another dimension, "There is a belief that there was a price bubble in the Japanese real estate market in the 1980s. Transaction costs were (and still are) rather steep in the real estate market, but that did not prevent a price bubble from occurring. That would suggest that

taxing transactions (Tobin's tax) is unlikely to ensure that prices would be tied to fundamentals." His argument questions the Tobin tax at a very fundamental level.

The primary obstructions are the central bankers. Says Baker, "There is a lack of support amongst most central bankers as they understand that it will create additional problems in the markets. There would also be problems with appropriating the proceeds of the Tobin tax. The World Bank has estimated that 1/3 of all aid does not reach its intended recipients." Other hindrances include a lack of universal application and the creation of incentives to move offshore. Argues Baker, "A lack of universal application could create systematic risk—exactly the opposite of what is needed in forex industry following the Allied Irish and Rijecka Bank scandals." Moreover, there are practical problems of instituting the tax globally unless all the central bankers unite.

All said and done it is undeniable that the Tobin tax is much more than merely a tax. The imposition of the tax would generate revenues to finance international development programs. Other than having the potential of minimizing speculation in forex, it has the potential of preventing the privileged factions of the society across the world from having the monopoly over the means that will determine the social future of the global financial system. ■

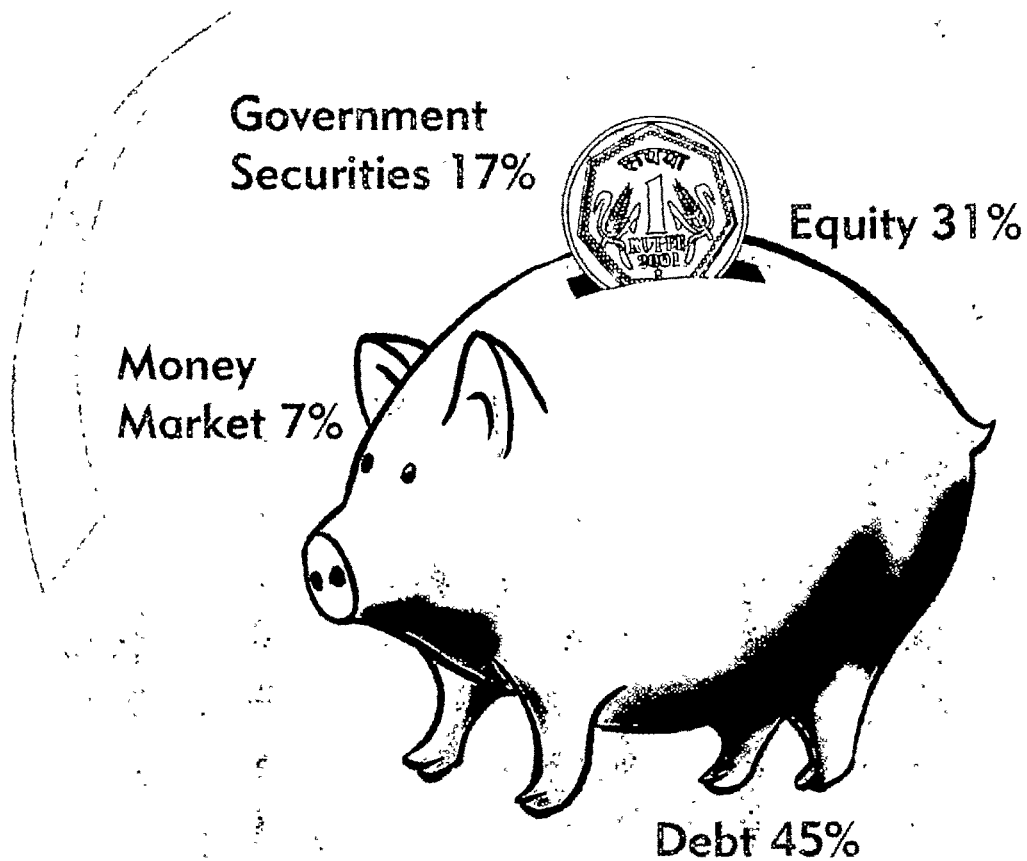
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Following each financial crisis, Tobin tax has confirmed the relative explanatory and analytical power in comparison to that of the monetarists

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Overview

A perceptible change is sweeping across the mutual fund landscape in India. Factors such as changing investors' needs and their appetite for risk, emergence of Internet as a powerful service platform, and above all the growing commoditization of mutual fund products are acting as major catalysts putting pressure on industry players to formulate strategies to stay the course.

In the changed scenario today, product innovation is increasingly becoming one of the key determinants of success. Given the growing shifts in investors' preferences owing to today's uncertain economic environment, anticipating trends of emerging investor needs and positioning products for these gaps pose greater challenges for growth for the industry players. Besides, attracting and retaining customers has also emerged as a key area where the need to have a greater focus is strongly felt.

Building and sustaining a powerful brand is also becoming an issue of paramount importance. With investors today having a range of products to choose from, effective communication is required to reach a wider audience. The success of a marketer in future would depend upon his ability to use the 360-degree compounding effect of media through a presence in all media interfaces with the investor.

Increased deregulation of the financial markets in the country coupled with the introduction of derivative products offers tremendous scope for the industry to design and sell innovative schemes to suit individual customer needs. As it is being increasingly felt, with the commoditization of products looking imminent, service to investor and performance would be major differentiators.

Another area where major shifts are taking place is distribution. It has taken a whole new meaning with the introduction of automated trading, clearing and settlement system. With increased use of technology the industry is witnessing a paradigm shift as far as customer service is concerned. Factors such as cross-selling through modes like banks, post offices and co-branded credit cards are bound to play a decisive role in the success of the industry players. This apart, aligning with the needs of the investors, protecting their interests, and an effective communication with them are the three key strategies that emerge with respect to the service paradigm.

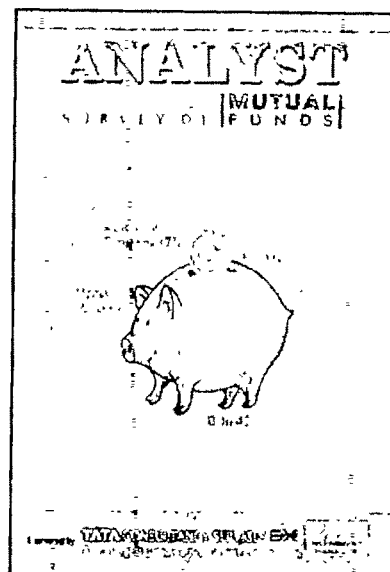
Quest for size to survive is bound to stimulate consolidation activities in a big way if the early signs of a few mergers are to be believed. Globally, it has been seen that the top ten players account for a greater part of the market share. With competition getting intense in the domestic industry, churning in the industry looks imminent.

Is the industry geared to deal with such impending challenges? To know it from who's who of the industry, read on.

CHARTERED FINANCIAL ANALYST

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(Editorial Team: N Janardhan Rao and Amit Singh Sisodiya)

The views expressed herein are those of the authors and do not necessarily reflect the viewpoint of the organizations with which they are associated

Growth Strategies: Key Challenges

By

Ved Prakash Chaturvedi

Chief Executive Officer

Tata Mutual Fund, Mumbai

While new features and added services to mutual funds will determine success, a key challenge for the industry will be customer retention and cross-selling.

The mutual fund industry in India has taken rapid strides during the past few decades. However, the private sector industry has come into existence only over the past seven years. In these seven years, the growth rate for the private sector has been excellent. The industry as a whole is still in its growth stage. This can be seen from the fact that the banking sector is 10 times in size compared to the mutual fund sector. In most developed markets, these two industries virtually rival each other in size. Thus it is clear that given the high propensity to save and the large Indian middle class as well as the low level of current penetration, the mutual fund industry is potentially on a high growth path.

Some of the key challenges facing the industry include the need for

- a. A broader product range.
- b. Geographical spread beyond the eight metros.
- c. Investor education
- d. Providing investor-oriented value added services and
- e. Over a period of time building trust with a large body of investors.

The key challenge facing the industry is that of educating the investor. Mutual funds are still not regarded as life cycle financial planning products among the middle class in India. Most savings continue to be lodged with the banking sector. While banks offer a suite of income products, mutual funds can offer a range of products investing in a variety of mix of instruments from equity to debt. Thus, through mutual funds, an investor can fine-tune his/her risk-return appetite. In addition, mutual funds offer liquidity as well as convenience and transparently declare their portfolio every month. Thus, an investor knows exactly where his/her money is being deployed and in case they are not happy with the portfolio, there is liquidity available for withdrawing at a short notice. Thus, investor education and appreciation of the benefits of mutual funds needs to spread to enable middle class savers optimize their allocation of exposure.

The penetration of mutual funds is still low. Part of the reason for this is the fact that mutual funds have not been actively sold through the conventional financial intermediation sources or systems like banks etc. Since investing money in a mutual fund is a high involvement decision, typically, investors will look for quality financial advice before investing. While the advent of the Internet as well as the gradual spread of mutual funds has increased awareness, a typical middle class saver would only have a limited perception and appreciation of what use mutual fund products can be to him or her. Like for other products, increase in penetration will happen only over a period of time and will depend significantly upon the ability of the industry to continuously launch innovative products appropriate to evolving investor needs.

Quality Services

Product innovation and product proliferation will increasingly be the key determinants of success for individual fund houses. In the past couple of years, new products like fixed maturity plans and plans oriented towards children have been launched and have found favor with investors. Investor's needs are dynamic. They evolve depending on the overall situation in the economy and the life cycle stage of the investor. The industry will need to clearly have a focus on researching and anticipating trends of emerging investor needs and positioning products for these gaps.

As customer needs evolve and the industry matures, product augmentation through value added services will become a key differentiator. The industry already offers across the board redemption for certain products, instant switch among asset classes and virtual interface through the Net. These value added services will need to continuously evolve. Looking into one's crystal ball, one can see services like ATM-linked investments and redemptions, cheque-writing on funds, cross-currency fund switches etc., as value added propositions in the near future. While new products and added services to varied mutual fund products will determine success, a key challenge for the industry will also be customer retention and cross-selling.

The search energy among investors has increased with added availability of information and new tools like the Internet. In the past, typically, an investor stayed with the fund house for a number of years. This is now changing rapidly and customer retention and repeat purchase by enabling past purchase satisfaction will need to be a key focus area for the industry. Most mutual funds are increasingly attempting to cross-sell their

products to the investor base for enhancing their appeal. While the competition among mutual funds has increased, the industry will also witness consolidation and mergers and acquisitions.

Growth through mergers and acquisitions will become a significant focus as the industry matures. We have already seen early signs of this where the large players are keen to acquire and grow.

Growth through mergers and acquisitions will become a significant focus as the industry matures

Outlook

In summary then, the potential growth opportunity for the mutual fund industry in India is enormous given the high savings rate, a growing savings class and very low penetrations. However, the growth trajectory for the industry will be determined by its ability to innovate and offer value added services in larger number of geographic centers to provide customer satisfaction. Competition for servicing investors in the industry has been increasing and some players are moving ahead of the others. Globally, it has been seen that the top 10 players get the bulk of the inflows. Since size is very important, many players in the industry would also look to grow through mergers and acquisitions. This will be positive for the industry as the stronger players will continue to introduce best global practices for an orderly growth of the industry. ■

Emerging Challenges

By

Nilesh ShahChief Investment Officer
Templeton Mutual Fund, Mumbai

The mutual fund industry will have to use the technology to reach masses so that services can be provided in a cost advantageous manner. The development of independent distribution network will be an important element of this strategy.

The Indian mutual fund industry has stagnated at around Rs. 100,000 crore assets for the last couple of years. The stagnated equity markets partly explain this, but the bulk of this is attributable to the indifferent performance by the players.

The origin of mutual fund industry in India can be traced back to the establishment of Unit Trust of India (UTI) in 1964. UTI grew at a rapid pace on the back of assured return schemes and patronage provided by the government directly (tax advantages) as well as indirectly (various bailout packages). The bull run of 1991 heralded the entry of bank sponsored players. The industry was badly affected by the bear run of the mid-90s. However, the entry of private players provided a filip to the mutual fund industry in the late 1990s.

In the fiscal of 1999, private players aggressively marketed their products with better service standards. The tech boom of FY 99 and secular decline in interest rates since FY 97 helped funds to post attractive returns at various points in time. All this ensured growth for select participants for small period of time but the industry as a whole got stagnated.

The future growth of Indian mutual fund industry will depend upon how the industry is able to push the products and pull the savings from the investors. The industry has to push itself to the investors on product, performance and services.

The mutual fund industry needs to introduce innovative products, which can satisfy investor's requirements. We have seen standard products being introduced by most of the players. These products have met investor's requirement in a bull market but failed to cultivate a long-term savings habit. Mutual funds have become a kind of trading instrument rather than investment vehicles. Off late we have seen the introduction of innovative products in the form of Floating Rate Funds, International Investment Plans, Exchange Traded Funds and Gold Fund. These products provide investors with a choice of investment. They are niche products, which can satisfy specific risk-return profile of an investor and create a long-term investment vehicle for him. The mutual fund industry has to bring many such innovative concepts to cater to investor requirements. The options could be on the High Yield Bond Funds, Principal Protected Funds, Long Short Funds, Arbitrage Funds, Dynamic Funds etc.

The other important area for the mutual fund industry will be to deliver performance. The investor wants a return on their investment. Mutual funds have sold performance in a bull market but miserably failed during the bear market. Concept of Risk Adjusted Return and Total Portfolio Return are still alien to investors. Most investors tend to evaluate fund performance on a short-term basis. There is a need to educate investor about risk-adjusted return and also the total portfolio return. Empirical studies in the US market have shown that the funds return tend to

Emerging Challenges

have a huge variance with the average investor's return. This is mainly because most investors enter the fund after it has shown top quartile performance. Investors also tend to exit when the funds are showing bottom quartile performance. The key to investors' return will be the funds' ability to outperform the benchmark index on a consistent basis without taking lot of risks.

The mutual fund industry will have to improve the service standards to reach investors. Today barring UTI and few other players, most mutual funds are concentrating upon metro investors. Even in a place like Mumbai, the existing penetration is far from satisfactory. The mutual fund industry will have to use the technology to reach masses so that services can be provided in a cost advantageous manner. The development of independent distribution network will be an important element of this strategy. Distributors will play a critical role in understanding investor requirements and suggesting suitable products. They will also have to play an important role in communicating feedback from both the sides.

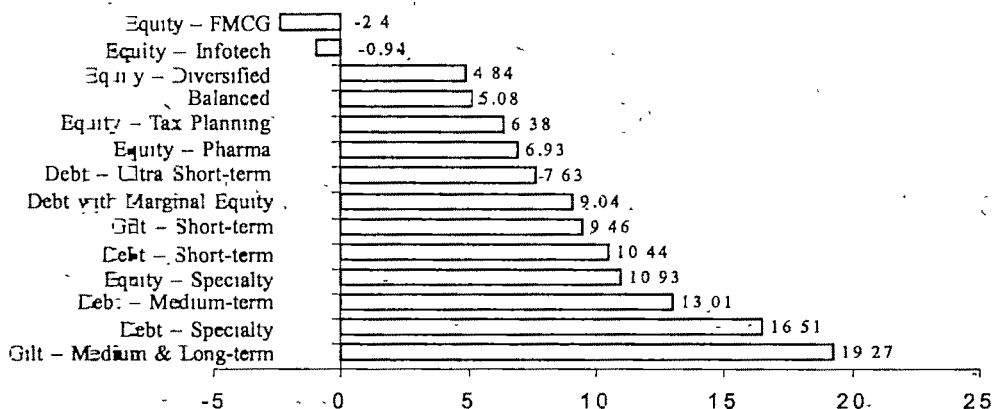
The mutual fund industry will have to pull savings from investors (both wholesale and retail) for channeling into productive investments for higher economic growth. A large portion of present day savings are allocated inefficiently as either the returns are not market linked or are routed through the

government sponsored products. The Indian mutual fund industry has a big responsibility in ensuring a smooth transition of flow of savings from government sponsored products to market-related products. Their biggest challenge will be in managing pension funds which has the backing of fixed return assurance from the Government. The mutual fund industry will have to proactively work towards educating investors about the pros and cons of market-related return on pension funds from assured return products.

The key to investors returning to mutual funds will be the funds' ability to outperform the benchmark index on a consistent basis without taking lot of risks

The mutual fund industry seems to be falling behind the insurance industry in terms of innovation. Some of the insurance companies have introduced good products and invested heavily in their distribution network. Competition between banking, insurance and mutual fund industry will be good for the consumers, as they will get the best of the products and services with the lowest cost. ■

Open End: Fund Categories Return Averages (as on June 4, 2002)



Source: Value Research

Investor Education

By

A P Kurian

Chairman

Association of Mutual Funds of India (AMFI),
Mumbai

With a wide range of fund categories to choose from and given the low level of awareness among investors, investor education needs to be given increased thrust by the industry.

The mutual fund industry consists of both equity and debt schemes. The debt schemes during the last two years have given very attractive rates of return. However, equity schemes, particularly the diversified schemes, mostly performed in line with the market. Regarding the relatively poor performances of the equity schemes, it is to be understood that whenever the market has fallen by a substantial portion, the NAVs of these funds have also suffered. It is some of the sector-specific funds, particularly the IT sector funds, which have given very poor performance. Unless the market improves, the performance will not improve.

As far as safety of investment is concerned, it is wrong to say that mutual funds are the safest investment avenues. There is no guarantee of the return. Neither there is a guarantee of the principal nor is there any insurance. From that point of view, mutual fund investment is not safe and it entails some amount of risk. People should understand that this is no myth, it is a reality. Unlike the banks or government securities, there is no assurance of anything. That is why creating

awareness among the investing community becomes more important. An investor should know that NAV could go down, and there could be no dividends also.

Regarding widening the reach of the industry, I think the slow market penetration is a matter of cost, because to go to smaller towns or distant places is a costly affair. So in the beginning the mutual funds would tend to concentrate on the rich pockets and also metropolitan towns like Mumbai, Delhi, Chennai etc. So it is a matter of time before they go to smaller towns and other pockets where there are savings.

On restoring the confidence of investors in mutual funds, I would say there are several things. First of all the industry needs to create awareness about benefits of investing in mutual funds. The investor must understand that mutual funds work differently from the other saving instruments like banks, post office, non-bank companies, or chit fund companies. They should understand that there is enough protection; there is a mechanism within mutual fund structure to protect the interest of investors. There is a trustee, an

The investor must understand that mutual funds work differently from the other saving instruments like banks, post office, non-bank companies, or chit fund companies

AMC, auditors, and there is SEBI. Thirdly, investors should do their homework properly. They should read the offer document, and the application, and should understand the annual report fact sheets which they receive.

AMFI is conducting investors' awareness programs along with other mutual funds as well as other bodies like FICCI, ICAI, IMC etc. Recently we made a presentation to more than 300 investors as to how mutual funds work, what are the advantages, what are the difficulties etc.

The mutual fund industry is one of the fastest growing industries in the Indian economy. This year our growth in assets has been around 11 percent. Today in terms of disclosure, transparency and standards, the mutual funds industry has taken some major steps. So in that respect the industry is mature, and which if positioned properly and with the

improvement in the equity market, has a very bright future.

As far as disclosure standards are concerned, I would like to say that our standards are second to none in the world. There has been a lot of improvement in the regulatory framework. What is important today is that the intermediaries i.e., the distributors, agents and brokers who are distributing and selling the mutual funds, need to become more disciplined and pass our AMFI test. They must register with AMFI and must become professional people so that they can advise their clients properly. ■

From AMFI Chairman's Desk

Looking back, the fiscal year ending March 2002 witnessed several developments in the mutual fund industry. The assets under management showed a modest growth of 11 percent to Rs. 1,00,594 crore. As many as 90 new schemes were launched and the gross mobilization was up by 77 percent to Rs. 1,64,523 crore, on a net basis the mobilization was down by 27 percent to Rs. 7,175 crore. The asset allocation showed a marked shift towards debt and government securities. On the performance side, while the Income Schemes gave competitive returns, the Equity Schemes remained generally depressed in line with the market condition. As in other industries, the trend of mergers and acquisition has become more pronounced in the mutual fund industry as well.

AMFI continues to play its role as a catalyst and initiator for setting new standards and refining existing ones in many areas particularly in the sphere of valuation of securities. A major initiative of AMFI during the year was the launching of registration of AMFI Certified Intermediaries and providing recognition and status to the distributor agents.

Looking forward, the ongoing refinements in regulations, improved transparency and disclosure along with dissemination of performance data in systematic manner and analysis by several research bodies, present an environment that is at once conducive and supportive for stimulating further growth of the industry.

Developing a cadre of trained certified intermediaries, building a wider retail base through market penetration and demonstrating commitment to best practices by strictly adhering to the guidelines and standards set by AMFI and the regulator are some of the key areas on which the members of the industry have to devote more attention as we go along nurturing the industry on healthy lines.

Brand Building: The Key

By

Ambareesh Murty

Associate Vice-President – Marketing &
Customer Service
ICICI AMC, Mumbai

The success of all marketing campaigns today is built upon the ability of the smart marketer to use the 360-degree compounding effect of media through a presence in all media interfaces with the customer.

With the evolution of our economy over the last few years, the Indian financial services sector today has assumed a position of pre-eminence consisting of a plethora of products like mutual funds, insurance and banking.

The marketing strategy for mutual funds in India has been that of evolving a customer need-based product value proposition, communicated to the consumer in the best, most efficient manner possible. While product values may change across businesses, as might the levels of involvement that consumers have with products and the set of media vehicles to communicate these values, the core marketing truths of simplicity, innovation and understanding the needs of a consumer do not.

The success of all marketing campaigns today is built upon the ability of the smart marketer to use the 360-degree compounding effect of media through a presence in all media interfaces with the customer.

The marketing of mutual funds in India can be looked at as a three-step process.

Creating Brand Awareness

The mutual fund market in India is going through the growth stage of its life cycle, therefore the emphasis is on the need to educate the consumer about the benefits of mutual funds, the varied nature of products that are available to the investor under the mutual fund umbrella and building and strengthening brand awareness. The box item on the following page details a possible awareness and relevance building cycle. Communication to clearly segmented pockets of customers uses a variety of media that include traditional media like press, outdoor and television, and interactive media such as the Internet.

The mutual fund market in India is going through the growth stage of its life cycle, therefore the emphasis is on the need to educate the consumer about the benefits of mutual funds.

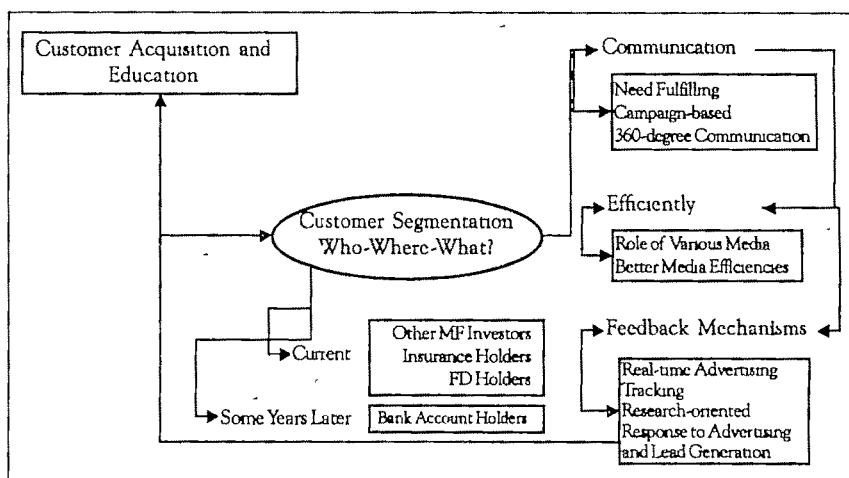
Brand Advantage

This is the second step towards creating a successful brand and is achieved through providing higher performance and service levels to the customer.

Customers can be empowered through 24-hour call centers, transaction capabilities on the Internet, and customer service walk-in locations.

These non-conventional interaction channels permit the consumer to interact with the brand at his own convenience and his own terms.

From the very beginning we have made the customer the center of all our efforts. We have set up 26 customer service centers across the country and launched a range of products suited to the investors' needs. Our vision is to provide the highest customer service standards in the country. The PruICICI InstaCall Service is another step in that direction.



Prudential ICICI Mutual Fund has launched the PruICICI InstaCall Service to take customer convenience to a higher level.

The PruICICI InstaCall Service will allow Prudential ICICI investors in India to call ICICI's Call Center round the clock, 365 days in a year to carry out transactions such as redemption, a switch or note a change in address. In addition to transacting, an investor can get updated information on his account balance, last five financial transactions, account statement etc. The investor can also access the latest Net Asset Values, product details and transaction history over the phone or the fax. Investors who enroll for this facility will receive the confidential Telephone Identification Number (TIN) with which they can access details of their account or transact on their account over the phone.

This is the first time an Indian Mutual Fund has launched a telephone service with such wide-ranging capabilities. The PruICICI InstaCall Service has been developed using sophisticated software, which integrates back office databases to the end-users' telephone.

While most financial service providers focus on making the sale of their product a convenient experience, our philosophy is to make the entire experience from purchase to redemption a delightful one for the customer. The PruICICI InstaCall Service will enhance the investors' post purchase experience substantially. This service will also enable us reach out to a wider customer base and provide superior service to all our customers.

Customer Loyalty

This is the ultimate evolution of the brand experience with a customer and is achieved post the successful completion of steps one and two.

Studies in developed markets have shown that strategies of nurturing current customers tend to be far more profitable than that of purely acquiring new customers. Therefore,

providing existing customers with added value (through bundling of products) helps increase the overall value proposition for the customer.

Cross-promotions such as in-house loyalty programs, co-branded credit cards and in-house lifestyle magazines play an increasing role in a marketer's tool kit for retaining the customer. ■

Product Innovations and Differentiation

By
M R Murali
Chief Investment Officer
LIC Mutual Fund, Mumbai

As investor knowledge increases it will show a demand for specialized products and services. The financial industry as a whole has to travel a few miles before we can get to that level.

The mutual fund industry in India has grown from a single US-64 to a total of 417 schemes presently available in the market. However, the figure seems miniscule when compared to the 13,000 odd schemes occupying the US market. The Indian market has metamorphosed into the predominant open-ended era from the close-ended one; it has ushered investors into a present risk based return environment from the security of the guaranteed return times, yet, the product offerings have been largely vanilla as in debt, equity and balanced schemes. The primary innovation of the Indian industry came in the form of insurance-linked tax saving products introduced by UTI and LIC Mutual Fund, but that was as far back as the pre-1990s. Product innovations otherwise seemed to have plateaued in the mutual fund industry although we have seen the occasional sector funds which caught investor fancy because of the tech boom, serial plans which seemed to be tailored for corporate investors and index funds. Mutual funds otherwise for various reasons seem to have adopted a very cautious approach to product innovations. But with the growth

in domestic financial markets, there is a variety of products that can be offered to our investors such as international funds, regional funds, real assets funds, utility funds, municipal funds, capitalization-based funds, commodity funds, natural resources funds, pension funds, structured funds etc., which are already a norm in the international markets.

The Indian industry is presently working towards making a conducive environment for two of the above mentioned categories viz., the real estate funds and the pension funds.

The domestic property market is extremely disorganized and needs to be brought within the grasp of formal economic activity. Real estate comprises of three types of properties viz., personal, investment and infrastructure properties. Generally, in developed markets investment in real estate can be either direct, or through holdings in equity of property companies or mortgage-backed securities and is quite a lucrative investment choice as it not only provides returns similar to equities in the long-term, but also offers a good hedge to inflation. However, it is available in India only through direct ownership wherein the tedious legal procedures, high costs and associated risks make it an unlikely investment choice. So the objective of domestic real estate investment funds will be to help investors invest in property conveniently, cost effectively and securely with the help of professional management, thus providing them opportunities for capital gains as well as regular income. A lot of groundwork still needs to be done before real estate investment funds are introduced in our market. The expected introduction of the proposed Securitization and Reconstruction of Financial Assets and Enforcement of the Security Interest Bill 2002 is one step in that direction, whereby

securitization companies and asset reconstruction companies will come into existence thus paving the way for easy availability of asset-backed securities or mortgage-backed securities and the viability of real estate funds.

Although not as disorganized as the real estate industry the pension industry in India also needs to wake up to the changing global economics. A burgeoning middle class population, increased life expectancy resulting in an increasing number of senior citizens, societal shift towards nuclear families, decreasing levels of job security, complete lack of a national social security system and an increasing sense of responsibility towards retirement benefits has prompted a review of the existing pension system. The need to change from the existing defined benefit system to a defined contribution system as is witnessed globally has now been acknowledged. As a result, private pension fund products will soon likely find their way in the domestic market.

Deregulation of the financial markets, development of the futures and options market, introduction of structured products such as collateralized bond obligations, collateralized loan obligations, credit-linked notes or credit-linked derivatives will provide hitherto unavailable investment avenues to fund managers and thereby lead to an increase in product innovations.

Product differentiation presently is on the basis of investment objectives, asset allocation performance and service. However, with the commoditization of products being inevitable, service and performance will skew investor preferences. As investor knowledge increases they will show a demand for specialized products and services. However, the financial industry as a whole has to travel a few miles before we can get to that level.

LIC Mutual Fund Bond Fund

The LIC Mutual Fund Bond Fund (LICMF) is a debt-based scheme offered by LIC Mutual Fund which is among the early institution sponsored funds

in the country, with more than a decade long experience in fund management as well as a healthy performance track record.

This fund was launched in March 1999 as an open-ended debt fund with no guaranteed returns. The objective of the fund is to generate reasonable returns with quality investments in debt and money market instruments. The fund has more than 60 percent of its investments in sovereign and AAA rated papers and the balance in AA and money market instruments so as to optimize returns for its investors with minimal credit risk. The minimum investment

With the commoditization of products being inevitable, service and performance will skew investor preferences.

amount in the LICMF Bond Fund is Rs. 5000 and additional investment can be made in multiples of Rs. 500 under two options viz., dividend and growth. It also offers additional benefits like the systematic investment and withdrawal options to serve regular investment and income needs of the investor. The fund has no sales load but there is a repurchase load of 0.50 percent for investments upto Rs. 50 lakhs if the repurchase takes place before the investment completes six months and 0.25 percent for investments greater than 50 lakhs if the repurchase takes place before the investment completes three months.

Since its inception, the fund has regularly been declaring dividends. It declared three dividends in FY 2001-02 aggregating 11 percent.

The initial mobilization by the fund was around Rs. 30 crore but in three years it has grown to cross a whopping Rs. 1300 crore. The growth in corpus is reflective of the investor support it commands on the strength of its performance. The fund is presently giving annualized returns since inception of around 14 percent. ■

Innovation@Work

By

S V Prasad

President

Zurich India Mutual Fund, Mumbai

There is tremendous scope for product innovations within the mutual fund industry. One of the most significant innovations was on the platform of convenience namely the turnaround time required for repurchase.

The Indian mutual fund industry, especially the private sector, is coming of age. Be it products, service standards, or transparency it is comparable to the best in any country. This is creditable given that the private sector was allowed to set up shop only in 1992 and the first set of funds went public in the latter part of 1993. A number of changes have been ushered by the industry taking advantage of the freedom given under the SEBI regulations. No load funds, dividend and growth plans in schemes, full disclosure of portfolio on a regular basis (in most cases, at least monthly), redemption turnaround of T + 1 (versus the regulatory requirement of T + 10), T being the transaction date etc., are all eloquent examples.

Like any other industry, which has started late here in India e.g., telecom or the IT industry, mutual funds too are leapfrogging in terms of development and innovations. If one looks at the history of the industry, even though nascent, one can see that there have been constant innovations. There is tremendous scope for product innovations within the mutual fund industry. Innovations here for the industry may not be completely new for the developed economies but nevertheless they have gone a long way in offering

products and services comparable to the best in the world to the Indian investors. The introduction of gilt funds, liquid funds, and sector funds all provide a vast range of financial solutions for the investors to choose from across virtually the entire risk-return spectrum. The last couple of years have seen a lot of innovations in the form of services being offered to the investors. And one is sure to see value additions being introduced into the products enhancing the value for the investors in future.

One of the most significant innovations was on the platform of convenience namely, the turnaround time required for repurchase. This has come down significantly to a maximum of T + 3 days. This has meant that the investors can utilize their money for much more than what was earlier impacting their returns and also the convenience.

Another innovation that the industry saw was in the field of distribution to make it more easily accessible to an ever-increasing number of investors across the country. For the first time in India a mutual fund started using the automated trading, clearing and settlement system of stock exchanges for sale and repurchase of open-ended dematerialized mutual fund units. Zurich India Mutual Fund, made available all its equity growth schemes and the balanced scheme on the National Stock Exchange through a special order routing mechanism developed in partnership with the NSE. Investors could purchase or repurchase units at the applicable NAV-based prices through any of over 2900 access terminals linked to the NSE spread over 400 cities. Soon, other mutual funds followed suit to take advantage of the already existing backbone of NSE to distribute their units across the country. Some mutual funds have tied up with select post offices to distribute their units. All

these have been done with one single objective in mind—to increase the penetration of mutual funds in the country from the existing 25 - 30 cities where it was available in.

Some service innovations have also been seen. Systematic Investment Plan (SIP) and Systematic Withdrawal Plan (SWP) were options introduced which have come in very handy for the investors to maximize their returns from their investments. SIP ensures that there is a regular investment that the investor makes on specified dates making his purchases to spread out reducing the effect of the short-term volatility of the markets. SWP was designed to ensure that investors who wanted a regular income or cash flow from their investments were able to do so within a pre-defined automated form. Today the SWP facility has come in handy for the investors to reduce their taxes.

Zurich India has gone a step further and introduced Zurichcheques, special, pre-issued, repurchase cheques. Unit holders can opt for these cheques at the time of investing in our range of debt funds—Zurich India High Interest Fund, Zurich India Sovereign Gilt Fund and Zurich India Liquidity Fund.

So, instead of going through the hassles of filling up a repurchase request form sending it to the Investor Service Center and then waiting for the cheque to be delivered to them, all they need to do is to simply bank the Zurichcheques with them, and save on time and effort. Better still, their money earns till the day the

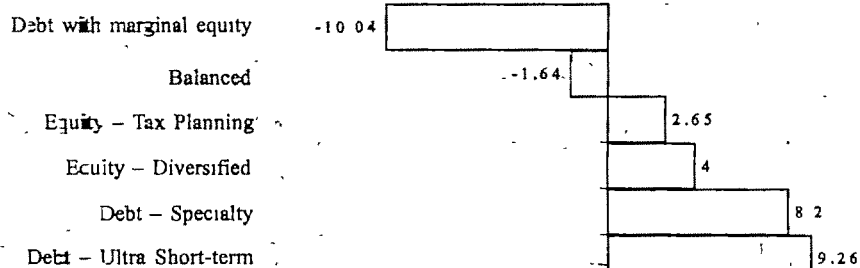
Zuricheques are cashed, rather than till the day they file for repurchase, therefore it is virtually T+0.

So now investors opting for SWP as a source of regular income can use these Zurichcheques to attain far greater flexibility and higher earning capability than the simple vanilla SWP. Greater flexibility because unlike in SWP, where an investor needs to fill up a SWP form, have it deposited at the ISC and wait for the cheques to reach him, the process for Zurichcheques is much simpler with no waiting period at all and there is also no fixed date or amount for which the investor's

Like any other industry which has started late here in India (e.g. telecom or the IT industry), mutual funds too are leapfrogging in terms of development and innovations

repurchase is processed. They can as per their requirements decide on the amount and date of repurchase. And higher earning capability because unlike in SWPs where their repurchase request is processed and the cheque mailed to the investor can take as much as three to five days during which the repurchase amount does not earn at all, here with Zurichcheques, the repurchase amount earns till the day it is cashed. This money is then immediately available for use. ■

Close End: Fund Categories Return Averages (as on June 4, 2002)



Source: Value Research

Product Differentiation: The Key

By

Rajan Mehta

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The innovation or differentiation should not be there just for the sake of it. It should really add value to the end investor either by way of instrument design or opening a new asset class.

Product innovation is an important part of evolution of any industry. It is also true in investment industry. The innovation or differentiation should not be there just for the sake of it or just for scoring brownie points for marketing. It should really add value to the end investor or the intermediary either by way of instrument design or opening a new asset class.

Even though one finds many claims of innovative products by various providers, in most cases the differentiation is miniscule. Big ideas in financial products are very few and occur after a long period of time.

A case in point is mutual funds which is one of the most popular investment products. There are thousands of schemes in existence today with claims of differentiation. But in terms of broad classification there are only three types of fund structures namely close-ended funds, open-ended funds and exchange traded funds.

One can trace the origins of close-ended funds to 1783. A gentleman named Daniel Parker who was a military contractor in George Washington's Army pooled in some money from European financiers to buy notes redeemable for goods. It was an extremely successful venture which saw an appreciation of 20 times in eight years. Subsequent to that many close-ended funds were launched. Over a period of time people realized that close-ended funds suffer from drawbacks like poor liquidity. Exit from the fund can be at a premium or discount to Net Asset Value (NAV) and for the fund company, this limits the corpus size. Hence there was a quest for a better structure.

In 1924, stockbroker Sherman Adams decided to take advantage of the bull market by buying shares into a pool of mutually owned funds where shareholders can buy and sell their shares at NAV. Even today this fund exists as Massachusetts Investment Trust with a corpus of \$12 bn (originally \$50,000 from 200 investors). The open-ended funds are of a superior structure since they provide liquidity to investors and this liquidity is at NAV related prices. For a fund company, they can generate more revenue since the corpus of funds can grow. However, over a period of time people realized that there are some problems with the open-ended fund structure as well. First of all the entry or exit into/from the fund can be at the end of the day prices only and secondly the long-term investor actually pays the price for short-term traders. The search continues for better structure.

In 1993 the American Stock Exchange launched S&P 500 Depository Receipt (SPDR also called Spider) which was the world's first Exchange Traded Fund (ETF). Even though close-ended funds have been trading on exchange, ETF was the first open-ended fund trading on exchange. Today the ETF structure has seen over \$120 bn pouring into it in more than 220 funds. It has become the fastest growing fund structure. In year 2001 alone the number of funds doubled from 100 to 200. ETFs also have their structural limitations. They are applied to only passive funds. The industry is now working on a mutual fund structure in the form of an ETF, which is suitable for actively managed funds.

In India, however, mutual funds have been introduced quite late but now the pace of new product introduction is faster. For example, even though UTI was formed in 1964, the first real close-ended scheme was the master share floated in 1986 (compared to 1784 in the US). Subsequently, Kothari Pioneer introduced the first open-ended fund Prima in 1993 (compared to 1924 in US). Then in 2001, Benchmark Asset Management Company introduced the first ETF Nifty BeES (compared to 1993 in US).

From investment point of view, there are two broad categories namely mutual funds and hedge funds. Long only style has been there since the first close-ended fund started while hedge fund was founded by A. W Jones group in US. Each of these investment styles have further classifications among themselves. Under long only funds one can have many different styles like active passive, quantitative, value, deep value, growth or momentum etc., while under hedge fund category, there are many differentiations in style like macro, long short, risk arbitrage, convertible arbitrage, relative value, managed futures etc.

In India, we still do not have hedge funds due to lack of regulations.

Big product ideas do not come frequently and even after they are introduced it takes time for them to be fully exploited.

It is recommended that the investor should scrutinize all new products with a magnifying glass especially those which sound too good to be true

Sometimes too many product features and differentiation can also confuse investors. The 80/20 rule is applicable here also. Increased complexity also makes things difficult to manage and it becomes quite susceptible to event risks. A case in point is LTCM. Another aspect is the cost. Many products include features, which add costs to the investor. For example, in the case of umbrella funds or fund of funds, which are very popular today, the costs go up to four percent per annum.

It is recommended that the investor should scrutinize all new products with a magnifying glass especially those which sound too good to be true.

AMEX, USA

Benchmark Asset Management Company (BAMC) is India's first company to exclusively focus on passive and quantitative approach for investments. It has introduced Nifty BeES, India's first exchange traded fund which tracks the Nifty index and trades on NSE. With this the BAMC has become the first company in Asia (excluding Japan) to introduce ETF. The Benchmark Asset Management Company is promoted by Niche group and professionals from Merrill Lynch. ■

Customer Care

By

Sheetal Joshi

Executive – Mutual Funds

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Developing effective marketing strategies can create awareness. Mutual funds have to ensure that distributors act as genuine advisors to clients, even if it means at an expense of them not investing in their own funds.

Mutual funds across the world have witnessed a drastic and dynamic change over a period of time. Surpassing the banks' deposit base, which till yesteryears was the largest depository of a nation's savings, mutual funds now rule the roost. Constant product innovation, customer focus and an effective marketing and distribution strategy has helped them grow threefold in the past 15-20 years.

But in India, there is still a lot of room for improvement. The industry is still in a fledgling stage. A lot remains to be done in the areas of marketing strategies and investor protection and awareness. The one area where the industry has a competitive edge is the wide array of products it can offer due to constant product innovation.

Product innovation involves bringing constant changes in the features of a product so as to cater to varied needs of investors. We have seen mutual funds launching different products that are customized to suit the broad investor categories like students, youth, middle-aged working class, affluent and retired persons. These products can be differentiated on basis

of their investment philosophy, time horizon, risk-return profile based on investment quality, average maturity and portfolio allocation.

In this race, mutual funds have come out with short-term funds, floating rate income funds, fixed maturity plans, asset allocation funds, P/E ratio funds and index funds.

Previously, an investor with an investment horizon of three months had the option to invest either in liquid or income funds. Liquid funds offer a very low return while an income fund with an average maturity of over four years carries greater interest rate / price risk. But, now the same investor can invest in short-term funds, where returns will be in line with risk he/she undertakes.

A conservative investor who wants to play safe can be recommended floating rate income funds. Here the interest rates on the securities is linked periodically to the benchmark rate prevailing in the economy.

Despite the above developments there is still a room for product innovation. In India we have very few schemes for retired people and for those who need regular income. Here an AMC should develop products that gives them the market-related regular returns and also avoid volatility. Similarly, child care plans and study plans can garner good collections from retail clients. But the lock-in period of 7-10 years makes them unattractive. If loan facilities are provided against these type of investments, collections can soar when compared to banks or post offices.

Value addition in terms of options like Systematic Withdrawal Plans (SWP) and issue of

bonus units can make products more attractive. Also, investors should be allowed to exercise Systematic Transfer Plan along with the SWP. Mutual funds can also introduce Trigger options where profits/losses would be booked beyond certain NAV returns. This helps the fund gain a competitive edge over others, as client base will widen by offering different schemes under one umbrella. For example, when an investor wants to switch from income fund to a short-term fund and the fund house does not have a short-term fund, then the money will surely go to the other fund.

However, the benefits of product innovation cannot be reaped unless backed by an efficient marketing and distribution strategy. The soaring collections and decent growth rate achieved by mutual funds in recent years is largely due to investments by corporates and HNIs. Retail participation across the country needs to be increased. Mutual funds distribute their products through agents, brokers and distribution companies whose reach is restricted to few big cities.

Mutual funds need to further beef up their distribution networks comprising banks and post offices. A strong agent network across the country should be developed as done by the likes of LIC and UTI.

As is widely known, product awareness presides over market penetration. Developing effective marketing strategies can create awareness. The main problem is that of investor awareness and education. Mutual funds should spend more time and money on educating distributors who in turn will impart the knowledge to investors. Mutual funds have to ensure that distributors act as genuine advisors to clients, even

if it means at an expense of them not investing in their own funds. This is the responsibility that the mutual funds owe to the society. We have seen in the recent past how distributors have sold tech funds to retired people who look at regular and a 100 percent safe return. There are few distributors who recommend investments after analyzing details such as age, risk-return profile and the investment horizon and their investment philosophy.

The key to the success of any business lies in customer satisfaction, besides the number of schemes available, flexibility and transparency.

The general perception among investors is that debt funds are risk-free. The onus lies on the distributors to explain the interest rate/price risk inherent in income and gilt funds.

Education apart, the key to the success of any business lies in customer satisfaction. The number of schemes available, flexibility and transparency that mutual funds provide is seen nowhere in other investment products. The investor enjoys benefits like direct debit/credit for purchase and sale, getting the redemption money in 24 hours. At any point of time an investor can know where his money is invested. Cheque-writing facility can be given so that the mutual fund investments can be operated as a bank account. Also, to avoid logistic delays, transactions through phone and Web should be used extensively.

Mutual funds in India have come a long way, but certainly a lot more can be done. ■

Growth through Focused Efforts

By

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Healthy competition among mutual funds will ensure that the industry continues to innovate new services to satisfy the needs of investors better than ever before.

Product Innovation

Over the years, mutual funds have been reshaping the financial landscape of investors, drawing in monies from various segments and providing a whole new range of products with easy access to financial products. Considering the fact that the current regulations provide ample freedom in terms of product designing and that mutual fund schemes have distinct objectives that characterize them, there is a room for product innovation. While the focus of the industry will remain on the plain vanilla products with add-ons to tackle the changes in the economic environment, the specialty products will help players in creating a niche for themselves.

Customer Focus

Mutual funds, especially in the private sector, have set new standards in providing prompt and efficient service to investors by taking advantage of technology. In fact, they have redefined the concept of service in the Indian context by helping investors in understanding economic trends and their impact on mutual funds, disclosure of portfolio, evaluating fund performance, answering questions on specifics of mutual fund investing and offering information/

advice through a newsletter etc. Moreover, healthy competition among mutual funds will ensure that the industry continues to innovate new services to satisfy the needs of mutual funds investors better than ever before.

Marketing Innovation

Over a period of time, the mutual fund industry has made progress in reaching a situation where investors are encouraged to make informed decision and the seller has to cater to this need. In fact, realizing this, banks and some of the distributors have started offering tailor made asset allocation service, bundled up with other services such as tax advice and a wide range of research services etc. In other words, they provide supermarkets that allow investors to select from a variety of schemes run by various mutual funds.

In a country like India, geographically diversified and densely populated, there is a need to have a network of distributors sufficiently large and varied to tap investments from all corners and segments.

In addition, distributors have started focusing on client profiling as it enables them to segment their key clients into groups with similar and meaningful characteristics, with influence and similar attitudes, perceptions and expectations. This helps in better understanding of investors' needs and wants and eventually enables them to offer schemes to suit their needs.

Internet has emerged as an enormous investment research source. The information and the tools that used to be in the hands of professionals are now in

everybody's hands. Investors know more about investing than ever before. Information is literally at the investor's fingertips and they have started using it to devise their investment strategies and research products. Never in the history of Indian mutual fund industry, has the information flowed so freely as it does today. The distributors who are not technology savvy will have to act quickly and empower themselves with the growing power of the Internet.

Information Technology (IT) has an important role to play in marketing of mutual fund products. In fact, IT enables much more sophisticated data-based marketing, leading to better relationship building. Net-based marketing has the potential to be highly relevant, personalized and productive.

Brand Building

As the mutual fund industry continues its effort to achieve a consistent growth, funds with a strong brand will be in a better position to market their products compared to the competition. Corporate image would really matter when prospects start looking at the products; rank them on the basis of image, performance, service and costs. While there is no shortcut for establishing a track record both in terms of fund management as well as customer service, a strong brand will ensure increased awareness among investing public and that will encourage distributors to push the products. Moreover, it will take them beyond traditional markets and enable them to expand geographical operations. Therefore, serious players will continue to do a focused and sustained brand building exercise.

Distribution Strategy

In a country as big as India, geographically diversified and densely populated, there is a need to have a network of distributors sufficiently large and varied to tap investments from all corners and segments. The mutual fund industry has already taken several initiatives to sharpen the skills of intermediaries as also find new methods of harnessing people's savings. To be

successful in this mission, the industry will have to ensure that only those distributors that have conviction about mutual funds being the most versatile and an ideal investment vehicle for investors are encouraged. The registration of distributors is a step in the right direction and will ensure their seriousness and quality. There is a need to develop channels like payroll subscription and independent financial advisors, which have been very successful in the West. It is quite obvious that the mutual fund industry needs to adopt a twofold agenda: Train the existing channels and develop new channels to attain wider reach as also to sell specialty products, once proper segmentation of the mutual fund market is achieved. Also, the industry needs to focus on making the products and services accessible to investors and target prospects in cost-effective ways.

Future Outlook

A long-term approach by the mutual fund industry will ensure prosperity. The lack of focused effort on the part of the industry, as well as distributors, in the past to expand the retail market has not helped the cause of the industry. As a result, the mobilizations from the wholesale segment dwarf collections from the retail segment. However, investors who have got used to assured returns are expected to re-examine their strategies and seek more flexible and potentially higher yielding investment products like mutual funds than the previously favored instrument offering administered rate of returns. The recent cuts in the small savings rates will hasten the process.

On its part, the industry will have to ensure a consistent performance to be able to win the confidence of investing public. In fact, apart from the performance, the industry needs to work hard on increasing its reach, making investing more simple as well as improve the quality of advice to the prospects. It is here that entities like banks, registrars and distributors, who have been an integral part of the industry, will have to play an important role in making this mission successful. ■

Building Investor Confidence

By

R Balakrishnan

Chief Investment Officer

First India Mutual Fund, Chennai

While it is true that the products are getting increasingly commoditized and performance variance is at the best or worse, plus or minus one percent, what mutual funds need to do is sell service rather than the product.

The mutual fund industry is at a nascent stage and the overall industry is expected to grow by around 15 percent per annum in the foreseeable future. It would perhaps be the only prudent investment vehicle for the retail investors. With the interest rates sliding by the day and with investors looking to new investment horizons to cater to their specific needs, there lies a huge opportunity for mutual funds. The after-sales service provided by many AMCs coupled with apt regulatory instructions from SEBI have gone a long way in building confidence in the minds of the prospective investors. So it is safe to state that the future offers a lot of promise for the mutual fund industry.

Mutual funds are viewed on advantages like diversification of portfolio, safety, liquidity, risk control and returns all in one package. It offers you investment options across a basket of stocks which are selected after painstaking research and which are monitored

rigorously. With the budget making most investment avenues less attractive, mutual funds stand to gain a lot by investment options like Systematic Withdrawal Plans, Systematic Investment Plans and Systematic Transfer plans.

Market Outlook

The mutual fund industry had a fairy tale 2001. The returns in the debt segment which is a function of interest rates, liquidity, inflationary levels were very favorable leading to extraordinary returns. Debt funds made returns, which investors normally expect from investing in equities. This was mainly on the account of bank rate cut and aggressive CRR rate cut by RBI. At the same time, vulnerability to event risks in the short-term led to high volatility in returns.

Equity mutual funds had another dismal year, largely a fallout of the wrong methods of selling and the failure to link time horizon to risk and return. Investors who have invested into equity mutual funds with a time horizon of less than three years are clearly a disillusioned lot. The real winners would be the investors who have adopted the systematic investment route.

High liquidity, active portfolio management based on a change in view of the bond market/interest rates, transparency in operation, benefits gained due to interest rate movements and from pooled investment are pluses which make mutual funds advantageous over traditional bank deposits. Debt funds should give more returns than those provided by alternative investment avenues in the same risk class.

Gilt funds in particular reported record performance giving absolute returns in the range of 20-25 percent last year. But, long-term gilt funds have posted negative returns for the last couple of months which can be attributed to stabilizing yields. Call money rates have risen from 6.00-6.25 percent to 6.50-6.75 percent. In the near future, the interest rates may not fall significantly so it is unlikely that any high gains can be seen as in the last year in this segment. At the same time, the continued violence in Gujarat and the renewed outbreak of violence in Kashmir has caused the usual uncertainty in the foreign exchange and bond markets.

Product Innovations: Emerging Trends: Product innovations are happening more on the debt side where volumes are high and derivative linked and hedge funds roll-outs may happen when the sentiments in the equity market improve. With private sector insurance companies taking off in India, we may see insurance linked products being launched subject to necessary statutory clearance.

Investment Strategy for Equity as well as Debt Funds: Typically we adopt a 'Top down Model' for asset allocation in debt schemes. Broadly the factors in that order are Economy; Interest Rate View; Determination of Average Maturity; Optimum Portfolio Mix; Security.

The scheme-specific aspects will govern the selection of security such as:

- Principal objective of the scheme.
- Risks inherent and the corresponding returns.
- Liquidity offered by the scheme.

The credit risk, liquidity risk and market risk are to be addressed before the selection of the security. And for equities, our basic investment strategy is a mix of top down and bottom up approaches.

Distribution Network

Our distribution strategy is clearly through select top quality distribution houses and banks. In a short span,

Brief highlights on the schemes offered by our fund house

We have launched three debt-based mutual fund products in February 2002 namely a) First India Income Fund; b) First India Liquid Fund; c) First India Gilt Fund. Our investment philosophy, in the income and gilt funds is to provide superior returns over a medium to longer time-frame, with focus on minimizing risk to the investors whilst in the liquid fund the focus is to provide high liquidity along with reasonable returns.

The primary investment objective of the income fund is to generate superior returns and achieve capital appreciation by investing in high quality debt instruments with low risk. The liquid fund would seek to conserve principal and maintain high liquidity by investing in high quality money market and debt instruments with lowest possible risk. The gilt fund aims to provide credit risk free returns and thus provide a medium to long-term savings plan. All the funds provide taxation benefits as is presently available under income tax laws. Our income fund has got "AAAF" rating from CRISIL.

we have tied up with all national level corporate distributors and regional distributors and the next step would be to tap the banking channel.

We have also planned a calendar of training sessions for our agents so that the mutual fund selling is transparent, informative and ethical.

Investor Servicing

At First India, we are working overtime to put the best of services delivery systems in place. While post-sales services are to a large extent standardized, the real challenge would be in the pre-sales area and that's where we would like to stand out from the herd. It is true that the products are getting increasingly commoditized and performance variance is at the best or worse, plus or minus one percent; what mutual funds need to do is to sell service rather than the product or price, for customers buy service more often than product or price. ■

Focus on Transparency

By
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The success of a mutual fund depends not only on the skills, expertise and the delivery standards, but also on the level of transparency and investor communication.

The concept of mutual fund was started in India way back in the year 1964 with the establishment of the Unit Trust of India and with the launch of Unit 64 scheme. But the mutual fund industry with multiple players came into being in the year 1987 when the Government of India permitted the State Bank of India and other nationalized banks to float their mutual funds. Since the mutual fund concept was new to India, investors were not aware of the risk associated with the investment in capital market. As a result, mutual fund companies thought it appropriate to bring out assured return type of schemes, a product similar to that of fixed deposits in banks. The risk and returns associated with the mutual fund products were not properly explained and understood by the investors. The schemes floated by the mutual funds during the initial period were perceived to be another banking product offered by the arms of sponsor banks. Though it would have helped some of the mutual funds to mobilize funds in the initial period, the growth of mutual fund industry received a severe setback. Mutual fund intermediaries viz., agents and distributors have also failed to educate the investors adequately about the concept of mutual funds and the risk and

returns associated with investment in mutual fund schemes.

Need for Investor Education

Realizing the need for investor's education, mutual funds have conducted several awareness programs at different centers in recent years. The Association of Mutual Funds of India (AMFI) has also conducted several seminars on mutual fund investment. The AMFI certification course for the agents and the distributors shall go a long way in improving the awareness of the investors about the mutual fund products and help the mutual fund industry to grow in a healthy way.

The mutual fund industry has seen tremendous progress during the last five years with the entry of many foreign players. SEBI guidelines/regulations on mutual funds have also brought out many systematic changes in the functioning of the mutual funds especially as regards the role of trustees and periodical disclosures by the mutual funds. Investors' confidence has also improved. This apart, many innovations in the product line have come in besides standardization in the product features and the disclosure system.

Transparency in Operations

The success of a mutual fund depends not only on the skills, expertise and the delivery standards, but also on the level of transparency and investor communication. The mutual fund industry cannot wish away certain risks associated with its schemes and it is incumbent on the players to provide all relevant details to the investors so that the investor takes an informed decision. Intelligent investors should clearly demarcate their investor horizons into short-, medium- and long-term, after careful understanding of the risk associated with investment and the expected return.

Most of the mutual funds have their own websites and contain full disclosures about the schemes, offer document, full portfolio and the balance sheet details etc. Besides, monthly/quarterly newsletters containing full details about the development and the performance are being mailed to individual investors. The level of transparency in their operation is very high and is being adhered to sincerely by most of the funds.

Investor Protection

SEBI, in consultation with AMFI has brought out several changes in the regulations solely with the idea of protecting the interest of the investor. Now the mutual fund industry is well regulated and the control systems are of international standards.

AMFI has initiated several steps to educate the mutual fund investors to take a well-informed decision about investments in mutual funds and the risk associated with such investments. AMFI's certification program for the agents and the intermediaries and mutual fund employees shall go a long way for the orderly growth of the industry. Now it has become mandatory for the agents/intermediaries to pass AMFI's certification exam to sell the mutual fund products. A well-informed agent is an ambassador of the mutual fund and can help the fund in promoting the industry.

Investor Education

Investor education emphasizes the need to have a thorough knowledge about the concept and the functioning of the mutual funds and can broadly be explained as under:

- The mutual fund is a vehicle to mop up small savings and to reap common benefits of investments in stock/debt/G-Secs market.
- A mutual fund is a trust and is managed by professional fund managers for a fixed fee and is not run on profit sharing basis.

- Mutual fund schemes are not similar to bank deposits.
- Risk and return profile of different types of mutual fund schemes are to be clearly understood.
- Demarcation of investment horizon into short-, medium- and long-term after understanding the risk and the expected return.

Value Added Services

Mutual funds, during the last one decade have brought out several innovations in their products and are offering value added services to their investors. Broadly, some of the important value added services that are being offered are:

- Electronic fund transfer facility
- Investment and repurchase facility through Internet
- Added features like accident insurance cover, medical claim etc.
- Holding the investment in electronic form, doing away with the traditional form of unit certificate
- Cheque writing facilities
- Systematic withdrawal and deposit facility.

Assets under the management of mutual funds under different types of schemes as on April 2002 are as follows:

	(Rs. cr.)
Income schemes	57614.00
Growth schemes	14093.00
Balanced schemes	16886.00
Liquid schemes	8423.00
Gilt schemes	4303.00
ELSS schemes	1512.00
Total	102831.00

The mutual fund industry saw tremendous progress during the last decade in spite of two capital market scams and several other problems faced by the mutual funds and the investors. The assets under the management of the mutual funds have more than doubled during the last 10 years. ■

Charting a New Course

By
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While the mutual fund industry faces new challenges, it will be old principles of integrity, trust and fiduciary obligations that will chart the course for continued success.

The mutual fund industry has been remarkably resilient, over the last one decade, navigating varying economic conditions, the ups and downs of the market, and the challenges from old and new competitors. Today, the mutual fund industry is the trustee of the nation's savings, with around Rs. 1,00,000 crore of Assets Under Management (AUM). As against this the aggregate deposits of Scheduled Commercial Banks (SCBs) as on May 3, 2002 stood at Rs. 11,86,468 crore. Hence, mutual funds AUM form just around 10 percent of deposits of SCBs. On the contrary, in US, there is more money in mutual funds than in bank deposits.

As evident from Table 1: Assets Under Management, the year 1999-2000 witnessed new records for the mutual fund industry with AUM crossing Rs. 1,00,000 crore growing by 65 percent besides, vast majority of equity schemes outperforming the market. The year ended March

2001 witnessed extreme volatility in the market and the AUM declined by about 20 percent to Rs. 90,587 crore. This is the first time in the last two decades that the industry has had such a decline in the total AUM. The erosion in the value of AUM is, however, confined only to the equity segment and this is reflective of the depressed market conditions. The fiscal year ending March 2002 witnessed several developments in the mutual fund industry. The AUM showed a modest growth of 11 percent to Rs. 1,00,594 crore as compared to negative growth in the previous year. The asset allocation showed a marked shift towards debt and government securities. On the performance side, while the Income Schemes gave competitive returns, the Equity Schemes remained generally depressed in line with the market conditions.

The churning within the mutual fund industry is in full swing as evident from Table 1. It is evident that UTI is losing out to other private sector players. An analysis of the figures shows that during the year 2002 while there has been an increase in AUM by around 11 percent, UTI on the contrary has lost more than 11 percent in AUM. Surprisingly, all other categories of funds have seen their AUM rise during the year with the biggest percentage gain coming from the private sector mutual funds. This category has shown a rise in AUM by around 60 percent for the year ending March 2002. Meanwhile, consolidation efforts in the industry are on full swing. The consolidations are expected to become more common as players begin to realize that managing very small corpus is not highly remunerative.

It is evident from Table 2 that the component of equity in the overall AUM has witnessed a downward trend since 1999 and this was more pronounced during the year 2000 and 2001 and continued in 2002 too. Despite the fact that debt forms the largest constituent of the AUM, investors still peg the fortunes of mutual funds with equities and paint the entire industry with the same brush, following the equity bloodbath.

Fund Management and Disclosure Practices

Investors believed that the mutual funds were managed by experts and would, therefore, provide superior investment perspective and judgments. The technology sector meltdown has badly hit the NAVs of both sector-specific as well as many diversified funds. The feeling now is that these so called experts have actually behaved like common investors as far as stockpicking was concerned and have made the same mistakes as the lay investor. This has led to a situation where the investing public is now actually questioning the ability of fund managers to outperform the market.

There is no debate among security analysts and fund managers that diversification reduces risk. The bone of contention only exists on the level of diversification needed in a portfolio. It means investing across diverse businesses to ensure that even if one or a few businesses fail to live up to their potential, the overall performance isn't dented too much. But the policies, praised for delivering during the technology bull charge, are now receiving criticism from all sides. Even in equities, when asset prices look like they have risen too fast, it is a good time to book profit by the fund managers.

The mutual fund's quarterly updates and composition of portfolio on various schemes furnished presently are an important source of information. Nonetheless alongside other key information about the fund's operating results, including management's discussion of fund performance and fund management fee, would allow shareholders to

Table 1
Assets Under Management
(Amount in Rs. crore)

Sl.No	Category	Asset Under Management			
		1999	2000	2001	2002
1	Unit Trust of India	53320	76547	58017	51434
	Growth (%)	77.87	+43.56	-24.21	-11.35
	% to Total		67.74	64.05	51.13
2	Bank Sponsored	5481	7842	3333	3970
	Growth (%)	8.00	+43.08	-57.50	+19.11
	% to Total		6.94	3.68	3.95
3	Institutions	2811	3570	3507	4234
	Growth (%)	4.11	+27.00	-1.76	+20.73
	% to Total		3.16	3.87	4.21
4	Private Sector (a+b+c)	6860	25046	25730	40956
	Growth (%)	10.02	+265.10	+2.73	+59.18
	% to Total		22.16	28.40	40.71
a	Indian	1016	2331	3370	5177
	Growth (%)	1.48	129.43	+44.57	+53.62
	% to Total		2.06	3.72	5.15
b	JV-Predominantly Indian	3040	9724	8620	15502
	Growth (%)	4.44	+219.87	-11.35	+79.84
	% to Total		8.60	9.52	15.41
c	JV-Predominantly Foreign	2804	12991	13740	20277
	Growth (%)	4.10	+363.30	+5.77	+47.58
	% to Total		11.50	15.17	20.16
	Total (1+2+3+4)	68472	113005	90587	100594
	Growth (%)		+65.04	-19.84	+11.05
	Total	100	100	100	100

Source: AMFI

evaluate the costs they pay against the services they receive. The present fee structure is based on AUM and is not performance-oriented. The fee based on performance, on the other hand, is charged by private equity funds and hedge funds. Investors are becoming increasingly aware of the significant, long-term effect of fund fees on their returns. The disclosures should be constructive for both investors and fund companies and put performance numbers in an appropriate context, serving to temper unrealistic expectations about fund performance.

Product Innovation and Differentiation

Worldwide, the financial sector has thrived on innovation. To stay competitive, mutual fund companies have to create and market new types of funds. As far as the innovative products are

Table 2 Asset Allocation of Assets Under Management (%)					
S.No.	Category	1999	2000	2001	2002
1	Equity	58	56	41	31
2	Debt	36	33	43	45
3	Money Market	4	11	16	7
4	Government Securities	2	0	0	17
	Total	100	100	100	100
Source AMFI					

concerned, we have already seen the launch of products tailored to meet the needs of investors. To quote some products, for instance, the Benchmark Asset Management Company has launched India's first Exchange Traded Fund (ETF) christened as 'Nifty BeES'. ETFs have gained popularity worldwide only in the past two to three years. The normal open-ended fund started in 1924 while ETFs were started only in 1993. So between the two structures there is a gap of nearly 70 years. The ETF, Nifty BeES would be tracking the S&P CNX Nifty Index. The company is also planning to come out in a phased manner, ETFs linked to other indices and various sectors.

The Union Budget 2002-03 holds important implications for mutual fund investors. The relative attractiveness of the dividend income received from mutual funds will come down in this financial year in view of abolition of dividend distribution tax and shifting the tax incidence on to the investors. Consequent to these changes, some mutual funds have come out with an alternate plan termed as Automatic or Systematic Withdrawal Plan (AWP) for investors in dividend plans. Such AWP may be more tax efficient in certain cases as the income from them is in the nature of capital gains and will be taxed as such.

The market has already witnessed some innovative offerings like the floating rate income fund from Templeton, Pioneer ITI- P/E ratio fund etc. The coming year would well prove to be exciting for investors as the mutual fund industry prepares for some ingenious product launches. Kotak Mahindra, for instance, is mulling over a capital guarantees product. Available in many developed countries, this

product essentially seeks to invest in debt products but invests the interest accrued in derivative products such as options. This allows the fund to limit the downside risk—since capital is intact always—without clamping down on the upside reward. But as of now, according to the SEBI, mutual funds cannot take any fresh positions in derivatives: They are only allowed to hedge their existing positions. HDFC mutual fund is toying with the idea of a realty fund. Given the liquidity constraints and issues related to real estate valuation, it might take some time for the regulator to finalize the rules of the game. But it will definitely be a boon for investors, as real estate has proved to be the best performing asset class in the long-term.

As a significant development, SEBI recently announced guidelines for mutual funds to invest in foreign debt securities. This is a progressive step taken by the Government in providing diversification in investment opportunities for the Indian mutual fund investor. To capitalize on the opportunity, Sun F&C Asset Management, India, has already launched a scheme called "fixed income securities fund" to provide investment options in foreign securities through mutual funds. The fund is looking at a low risk strategy basically investing in triple A rated countries and securities. For the first time the investor will be able to hold dollar denominated assets by buying rupee funds and effectively converting them. For the first time the investor can invest in a number of currencies and it would benefit the investor because they will be diversifying the risk. It might not give high returns but it will give a different country and currency risk.

Banks' aggregate deposits has already crossed Rs. 10,00,000 crore vis-à-vis mutual funds AUM which is still just at Rs. 1,00,000 crore. The softening of deposit rates should actually result in lots of interest in debt funds. Banks are at a disadvantage in offering attractive rates on deposits, as they need to maintain the statutory reserves, capital adequacy and have to do priority sector lending. Besides, they also have a

Charting a New Course

very high cost of physical branch network. All these pointing towards inflexible cost structure for banks. Hence, debt funds have a bright future and mutual funds still have a long way to go on capitalizing on this opportunity.

Looking at developed mutual fund markets, we see products like mortgage-backed securities, which is now developing in India. We don't have real estate investment trusts and precious metal funds. Normally people buy gold as an investment. But they can also give it to a fund manager and get it hedged properly. The new products can also include funds across various precious metals. We have not seen even the tip of the iceberg in terms of the product range that can be available.

Marketing Innovation and Distribution Strategy

It is well known that online trading has made it cheaper and easier for individual investors to buy their own stocks. Separately managed accounts also pose a threat to mutual fund sales levels, as a client can open a separately managed account with as little as Rs. 1,00,000. Thanks to technology, which has provided better software and portfolio management systems, investment managers who in the past would take institutional accounts with a minimum of Rs. 10 lakhs or higher are more willing to take much smaller accounts, including retail accounts. Financial advisers increasingly are attracting investors from funds by offering customized portfolios, and services over the Internet that hold out the prospect that individuals will be able to create and manage their own portfolios or create a virtual mutual fund online, consistent with the investor's risk tolerance, time horizon and tax situations. In other words, technology is making mass customization more feasible. The fund industry has to respond to these competitive pressures and rapid technological changes. Some funds have a very strong brand image, a very good service standard and a 24-hour redemption facility in the main centers, which brings in true liquidity, besides, no entry/exit load. Some funds have also pioneered the direct

credit facilities in banks, whereby redemption cheques get directly credited to their bank accounts.

Mutual funds normally would respond to the competitive environment with overly aggressive advertising. A number of funds achieved extraordinary triple digit returns in 1999 and 2000. Few investment professionals, including the fund managers who achieved these returns, believe that these numbers are sustainable. Advertisements that lead investors to expect these returns are at best opportunistic; at most, they are misleading.

The main categories of mutual funds investors can be broadly classified under, corporate clients; High Net Worth Individuals (HNI) and retail customers. A different marketing innovation and distribution strategy has to be made to each category. Corporate clients are savvy, they know exactly what they want and where to invest and laborious negotiations are hardly required and this group swarms to debt, liquid and other similar funds, often speedily moving money in and out of funds at very short notice. With high net worth individuals, marketers often play the role of investment advisors to make them into placing their money with mutual funds. These individuals are big-ticket investors, with little time or inclination to manage their wealth. Besides, for both categories, the tax breaks provided on mutual fund investments provide additional temptation. But retail investors remain stubbornly slow in moving off the starting block. Most Indian investors still have a fixed interest returns mindset. A deep-seated desire for straightforward and secure returns also keeps them addicted to more traditional forms of investments such as bank deposits. Unfortunately, the distribution and knowledge of mutual funds has been restricted to select cities. Major portion of the money poured into debt comes from the three metros i.e., Mumbai, Delhi and Kolkata. Nearly 50 percent of equity money comes from these cities as well. It is the corporate customers and cash-rich individuals who are the driving force of mutual fund activity in the country today. While the corporate segment accounts for 40-50

Charting a New Course

percent of the value of business, the retail segment forms only around 10 percent. Indeed, beyond the big cities, very few households view mutual funds as alternative savings vehicles. Clearly, there is still a long way to go when it comes to winning the hearts and minds of retail investors. A better understanding of mutual funds is crucial if the industry is to grow to greater heights. It also highlights the urgent need of training financial advisors on mutual funds, who can then offer professional advice to investors. In their attempt to improve customer access, fund houses apart from the usual national and regional distributors, brokers, sub-brokers and banks, are eyeing unexplored possibilities. IDBI Principal, for instance, has joined hands with the department of posts for the sale of mutual fund products through post offices, for the simple reason that a product sold at the post office carries some assurance of credibility, at least in the investor's mind.

Regulation

Clearly regulators must keep up with changes in the industries they regulate. There is also a lesson here that illustrates the benefits of best practices that go beyond legal requirements. It apparently never dawned on the operators of the Titanic that the largest—and safest ship—in the world, would ever need to use its lifeboats. As the financial services industry undergoes consolidation on a global scale, and wrestles with the issues brought about by technology and competition, the regulator will be called upon both to provide the flexibility needed to accommodate change, as well as to ensure investor protection. Technological changes and issues raised by increasing competition, and industry consolidation undoubtedly raise important issues for the mutual fund regulator.

Conclusion

Global giants such as HSBC and Deutsche are moving beyond over the counter banking and

looking for newer ways to boost their business and decided to tap the booming retail market by starting a clutch of mutual funds. Standard Chartered has already made its presence felt after launching its asset management company two years ago. Today, Standard Chartered has Rs. 3,400 crore under management and has a strong presence in debt funds. Nevertheless, it seems the banks are convinced that greater growth is round the corner. The industry in India is a miniscule fraction of what it is in the US and the amount of mutual funds is only 10 percent of the money in bank deposits. In the US, there is more money in mutual funds than in bank deposits. The international banks also have other reasons for starting the mutual funds. Profits from corporate banking are declining and most banks are turning towards retail banking. Therefore, they must offer a portfolio of services that will attract customers. The new players are also entering at a time when consolidation has started to take place. Though banks are entering a business that has a potential for growth there are many competitors already fighting for a share of the pie.

It is worth mentioning that the mutual fund industry has been able to avoid the scandals that have plagued some in the financial services industry because of its honest and fair dealings. Indeed, maintaining this tradition of integrity, in large measure, has been the mutual fund industry's prescription for success. In closing, the mutual fund industry's success is dependent on research capabilities, investment according to the fund's stated investment objectives, accurate valuation of investments, and to do all that for a reasonable and fair fee. While the mutual fund industry faces new challenges, it will be old principles of integrity, trust and fiduciary obligations that will chart the course for continued success. ■

Survival Strategies

By
R J Chand
Managing Director
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There is a competition among the mutual funds to have as many schemes as possible. Since the industry is in its early growth cycle, this trend may continue for some time and get stabilized subsequently.

Consolidation in the mutual fund industry in the near future The mutual fund industry in our view is fragmented, looking to the total size of the business. Given the low corpus of some of the funds, the fee income therefrom may not be sufficient to create a viable operating model. Therefore, the most important thing for any fund would be to achieve a critical mass by increase in business, acquisition, merger etc., within a reasonable time-frame.

The future of the number of joint ventures and alliances that have been the hallmark of mutual fund industry The future as such looks bright for such joint ventures and alliances but subject to compatibility between the two partners. We have seen in many cases in the manufacturing sector, that in case of alliance with global majors, the initial years are quite fruitful. However, after four to five years, differences cropped up in a few cases between the partners and that led to an eventual separation. Therefore, the ability to work together on a long-term basis is the key and both partners need to be convinced on an ongoing basis that the other ally is adding significant value to the business.

The measures undertaken by various fund managers to boost performance in spite of the falling equity markets and decreasing inflows In view of the overall falling trend in the equity market, the possibility of a broad market rally would be rather limited. In the above situation the fund managers are likely to concentrate on sectors that would be outperforming the market. Indian stock market has seen sectoral play wherein even in a stagnant market, certain sectors tend to do well. The fund managers would be following a "Top-Down" approach, wherein they would first identify the growth sector and thereafter pick individual companies within the sector.

Changes in the structure of the schemes, wrapping up or consolidating some schemes or new schemes that have been brought into the foray by mutual funds Although there is a case for consolidating some schemes, the trend appears to be launching more schemes seemingly to attract investors with different preferences. There is a competition among the mutual funds to have as many schemes as possible. Since the industry is in its early growth cycle, this trend may continue for some time and get stabilized subsequently.

Future of the mutual fund industry in the next two to three years Overall, the future looks quite bright in line with economic recovery and growth. However, the key factor would be the continuation or otherwise of the different tax treatment of mutual fund dividend income and interest income. The mutual fund industry has done very well to use the present period to extend, reach and enlarge the asset base. Once the asset base is sizeable, economies of scale would be achieved bringing down the cost of operations and enhancing returns for investors. ■

Mutual Fund Report Card

Schemes have been arranged in the descending order on the basis of their respective NAV returns (%). The returns are as on June 10, 2002.

Equity Funds					Debt Funds				
S.No.	Scheme Name	Quarterly	Half-yearly	Yearly	S.No.	Scheme Name	Quarterly	Half-yearly	Yearly
1	Reliance Vision	26.18	46.83	59.83	1	PNB Debt Fund – Growth	0.83	5.00	16.49
2	JM Basic Fund	(1.17)	77.54	54.69	2	JM Income – Growth	1.26	5.42	16.13
3	Pioneer ITI Prima Fund – Growth	5.18	31.81	47.34	3	JM Income – Bonus	1.26	5.42	16.13
4	Taurus Bonanza Exclusive Growth Scheme 95	12.86	32.46	47.02	4	Birla MIP – Growth	1.84	5.99	14.90
5	Pioneer ITI Prima Fund – Dividend	3.95	30.23	45.58	5	Birla MIP – Payment	1.84	5.99	14.90
6	Reliance Growth – Growth	20.70	37.02	40.62	6	Zurich India High Interest Fund – Growth	2.10	4.92	14.88
7	Reliance Growth – Dividend	21.13	36.91	40.42	7	Cancigo	0.44	4.53	14.87
8	Birla IT Fund – Dividend	0.26	19.62	38.83	8	Pioneer ITI Income Builder Account – Growth	1.65	4.96	14.81
9	Birla IT Fund – Growth	0.24	19.40	38.21	9	DSP ML Bond Fund – Growth	1.34	4.66	14.69
10	UTI Growth Sector Fund – Petro	10.77	58.96	38.11	10	Alliance Income Fund – Growth	2.15	5.95	14.61
11	SBI Magnum Sector Umbrella – Contra	0.65	28.07	33.21	11	KM K Bond Wholesale – Growth	1.52	4.87	14.58
12	HDFC Tax Plan 2000 – Growth	6.35	21.16	32.82	12	Alliance Income Fund - 54EB – Growth	2.16	5.94	14.58
13	HDFC Tax Plan 2000 – Dividend	5.62	20.33	31.92	13	Alliance Income Fund - 54EA – Growth	2.09	5.90	14.55
14	GIC Fortune 94	4.54	29.64	31.42	14	IDBI-PRINCIPAL Income Fund – Growth	1.73	4.84	14.37
15	Dundee Tax saver Fund	(4.37)	8.79	26.28	15	SUN F&C Money Value Bond – Growth	1.78	4.81	14.34
16	Zurich India Equity – Growth	(1.12)	15.18	24.92	16	PNB Debt Fund – Dividend	0.16	4.23	14.24
17	Zurich India Equity – Dividend	(1.12)	15.14	24.31	17	HDFC Income Fund – Growth	1.38	4.42	14.17
18	Alliance Basic Industries – Growth	(0.47)	22.16	22.45	18	Birla Income Plus – Growth	1.68	4.87	14.15
19	Alliance Basic Industries – Dividend	(0.47)	22.04	22.33	19	KM K Bond Deposit – Growth	1.41	4.63	14.12
20	SUN F&C Resurgent India Equity Fund	8.50	11.88	20.63	20	Pioneer ITI Children Asset Education Plan	1.55	4.92	14.03
21	Prudential ICICI Tax Plan – Dividend	(4.27)	9.16	19.91	21	Pioneer ITI Children Asset Gift Plan – Dividend	1.55	4.92	14.03
22	Prudential ICICI Tax Plan – Growth	(4.31)	9.05	19.79	22	Pioneer ITI Children Asset Gift Plan – Growth	1.55	4.92	14.03
23	DSP ML Technology.com Fund	(3.95)	12.76	18.14	23	UTI Mahila Unit Scheme	3.51	10.48	13.99
24	Zurich India Top 200 – Dividend	(1.44)	12.43	17.04	24	IL&FS Bond Fund – Growth	1.29	4.44	13.97
25	HDFC Growth Fund	(2.98)	11.74	16.74	25	SBI Magnum Income – Growth	0.99	4.77	13.74

Gilt Funds				
S.No.	Scheme Name	Quarterly	Half-yearly	Yearly
1	Tata Gilt Securities Fund – Growth	-1.35	5.98	24.78
2	KM K Gilt (Serial) 2013 – Growth	1.00	6.82	24.55
3	DSP ML G Sec Plan A Long Duration – (G)	0.31	5.63	23.11
4	Templeton GSF – Growth	-0.31	5.78	22.85
5	Birla GPLT – Growth	0.36	5.68	22.84
6	Zurich India Sovereign Gilt – Provident Plan – Growth	-0.10	3.55	21.84
7	KM K Gilt 98 – Investment Plan – Growth	-0.34	5.48	21.21
8	KM K Gilt (Serial) 2013 – Dividend	-0.06	4.31	21.11
9	SBI Magnum Gilt LTP – Growth	0.43	4.56	20.84
10	Prudential ICICI Gilt Investment – Growth	-1.07	4.45	20.57
11	JM G Sec – Provident Fund	1.13	5.43	20.26
12	Chola Gilt Investment – Growth	1.10	5.26	20.05
13	DSP ML G Sec Fund Plan A Long Duration – (E)	-0.87	4.39	19.84
14	Alliance Govt. Securities Fund LT – Growth	1.69	6.79	19.78
15	KM K Gilt (Serial) 2011 – Growth	0.93	5.69	19.59
16	Tata Gilt Securities Fund – Dividend	-2.53	2.96	19.33
17	LIC G Sec Fund – Growth	2.14	6.49	19.12
18	Dundee Sovereign Trust – Growth	0.23	3.08	18.82
19	Zurich India Sovereign Gilt – Provident Plan – Div	-0.49	2.55	18.77
20	JM G Sec Regular Plan – Growth	-0.06	3.71	18.25
21	Templeton GSF – Dividend	-1.42	3.17	18.20
22	Birla GPLT – Dividend	-0.62	3.55	18.13
23	Prudential ICICI Gilt Investment – Dividend	-1.07	3.47	17.73
24	Cangit PGS – Growth	-0.26	4.20	17.41
25	Birla GPI Plan – Growth	0.23	3.70	17.28

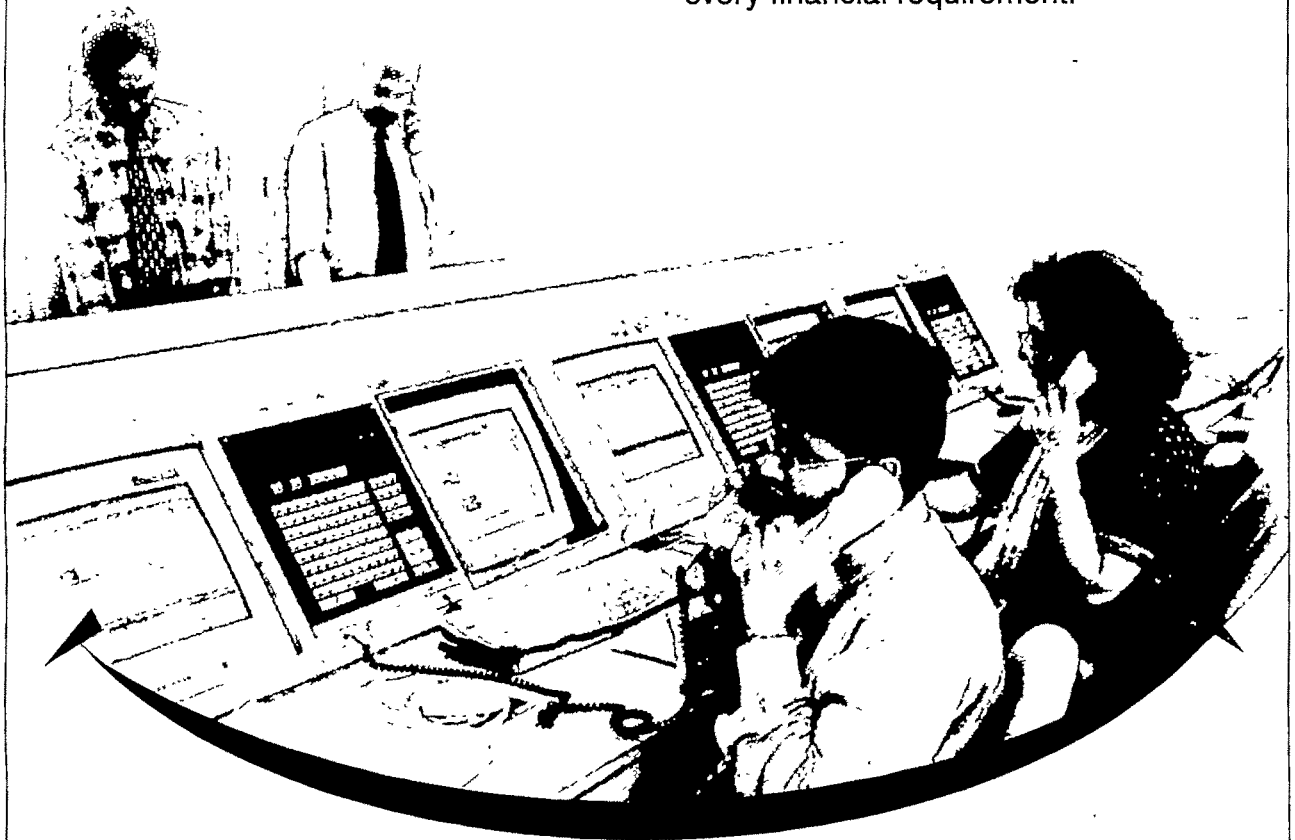
Sector Specific Funds				
S.No.	Scheme Name	Quarterly	Half-yearly	Yearly
1	JM Basic Fund	-1.17	77.54	54.69
2	Birla IT Fund – Dividend	0.26	19.62	38.83
3	Birla IT Fund – Growth	0.24	19.40	38.21
4	UTI Growth Sector Fund – Petro	10.77	58.96	38.11
5	SBI Magnum Sector Umbrella – Contra	0.65	28.07	33.21
6	Alliance Basic Industries – Growth	-0.47	22.16	22.45
7	Alliance Basic Industries – Dividend	-0.47	22.04	22.33
8	DSP ML Technology com Fund	-3.95	12.76	18.14
9	Birla MNC Fund – Growth	-1.22	9.85	15.68
10	Birla MNC Fund – Dividend	-1.19	9.64	15.49
11	UTI Growth Sector Fund – Pharma and Healthcare	-1.28	3.26	13.16
12	Pioneer ITI Pharma Fund	-0.72	6.51	12.14
13	UTI Growth Sector Fund – Brand Value	-10.48	-1.37	11.45
14	Alliance Buy India Fund – Dividend	3.93	3.32	10.61
15	Alliance Buy India Fund – Growth	3.93	3.32	10.61
16	Prudential ICICI Power	1.21	10.41	9.30
17	SBI Magnum Sector Umbrella – Pharma	3.30	2.29	7.65
18	Pioneer ITI FMCG Fund	-4.14	-3.21	7.16
19	Tata Select Sector Fund	-7.18	8.04	6.26
20	Prudential ICICI FMCG – Dividend	-4.83	-5.29	2.06
21	Prudential ICICI FMCG – Growth	-4.87	-5.29	2.01
22	IL&FS eCom Fund	-5.25	0.66	0.65
23	Chola Freedom Technology – Dividend	-2.03	4.32	0.34
24	Chola Freedom Technology – Cumulative	-2.25	4.11	0.22
25	Tata Life Sciences and Technology Fund	-6.83	-1.93	-1.42

Balanced Funds				
S.No.	Scheme Name	Quarterly	Half-yearly	Yearly
1	Canpremium (RC)	9.90	8.98	24.93
2	Zurich India Prudence Fund – Growth	1.04	11.58	24.29
3	Zurich India Prudence Fund – Dividend	0.94	11.52	24.21
4	JM Balanced – Growth	0.43	6.82	19.14
5	Escorts Balanced Fund – Growth	3.21	13.02	18.45
6	UTI US 95 – Dividend	3.59	9.50	18.32
7	Dundee Balanced Fund	-2.58	7.11	18.27
8	Escorts Balanced Fund – Dividend	1.60	11.26	16.60
9	Franklin India Balanced Fund – Growth	-0.70	6.85	16.22
10	UTI US 95 – Growth	3.77	10.41	14.38
11	HDFC Childrens Gift Fund – Saving Plan	2.18	4.63	14.11
12	HDFC Childrens Gift Fund – Investment Plan	-2.83	4.65	13.98
13	Franklin India Balanced Fund – Dividend	-0.93	6.21	13.70
14	Pioneer ITI Balanced Fund	-3.38	9.58	13.03
15	Sundaram Balanced Fund	0.39	7.79	10.88
16	Centuple +	-2.88	1.69	9.76
17	KM K Balance – Growth	-1.23	4.44	9.41
18	KM K Balance – Dividend	-1.23	4.44	9.41
19	Alliance 95 – Growth	-2.76	5.85	9.10
20	UTI CCCF-93	0.00	4.61	8.57
21	Pioneer ITI Pension Plan – Growth	-1.13	3.84	8.26
22	Pioneer ITI Vista Fund – Growth	0.20	2.66	8.16
23	Pioneer ITI Vista Fund – Dividend	0.00	2.77	8.12
24	HDFC Balanced Fund – Dividend	-5.78	3.55	7.72
25	HDFC Balanced Fund – Growth	-5.78	3.55	7.72

Source: www.mutualfundsindia.com

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CASE STUDY

Nissan Motors

Guided by the gaijin

The worst seems to be over for Nissan Motors. Led by *gaijin* – outsider – Carlos Ghosn, Nissan Motors has put an end to its string of loss making years and is stepping firmly towards sustained profitability. The turnaround of Nissan has been achieved in a remarkably short period of time but the challenge now is to sustain the upside.

How much time does it take to turnaround a terminal organization and put it back on track? Carlos Ghosn, the highly influential and successful CEO of Nissan Motors would probably say 'less than three years'. That is exactly the time he took to turnaround Nissan Motors, an ailing Japanese carmaker burdened with \$19 bn debt in 1999. For a company that had spent a good part of the decade of 1990s in the red, bouncing back towards an optimistic future is a great achievement. And the person who deserves all the credit for this is Carlos Ghosn, the turnaround expert of Renault.

The seeds of Nissan's successful turnaround were sown when Renault, the French carmaker bought a 37 percent stake in Nissan in 1999. By then, Nissan had been scouting for suitable partners for some time and had also approached DaimlerChrysler and Ford who did not show any interest. Renault, a company much smaller than Nissan, came to its rescue by purchasing 36.8 percent stake in Nissan for \$5.4 bn. Many feared that the sum was huge enough to ruin Renault if the rescue bid flounders. But Ghosn's stint at Nissan proved the fears baseless. Nissan expects to report a consolidated operating profit of 490 bn yen (US \$3.92 bn, €4.50 bn) and a consolidated net profit after tax of 372 bn yen (US\$ 2.97 bn, €3.42 bn) for the year ended March 2002.

Nissan in the 1990s

The problems in Nissan were an intricately woven web. Dull, unexciting and ageing models, mountains of debt, large number of plants, and large number of workers. The moves initiated by

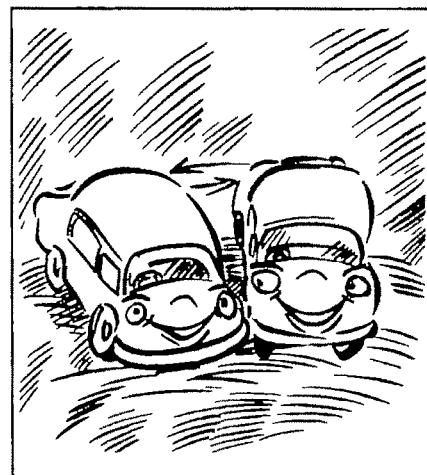
Ghosn were not magic portions but strategies known to have worked the world over. As he himself admits it was management craft coupled with objective assessment. But what he brought into Nissan was the initiative to take those measures. People at Nissan knew what was to be done but what was lacking was a firm hand that would push the button.

By the time Renault came into the picture in 1999, Nissan had been making losses since 1992 with the exception of one year, 1996. Its total domestic market share fell down from 17.4 percent to 13.3 percent at the end of first half of 1999; its global market share came down from 5.8 percent in 1988 to 4.9 percent in 1999 and its net indebtedness was more than 2.1 tn yen. Soon after it had bought the stake in Nissan, Renault sent a team headed by Ghosn to turnaround the fortunes of ailing Nissan. Within months of association with Nissan, the team

Problem areas identified by Ghosn at Nissan included lack of profit orientation and not enough focus on customers among others

objectively studied the company and identified the core problem areas of Nissan as well as the strong upside that would pull Nissan out of the mire. A thorough diagnosis of Nissan revealed the following major problem areas, all of which had to do with the mindset and attitude that spreads across the company. Lack of profit orientation, not enough focus on customers, lack of cross-functional, cross-border, intra-hierarchical lines of work, lack of a sense of urgency and finally no shared vision or common long-term plan. The biggest challenge for the team from Renault and Ghosn was to overcome these mental blocks.

Some of these problems stemmed from the age-old heritage of Japanese business culture. Philippe Lasserre, Professor of Strategy and Asian Business, Insead Graduate Business School,



Singapore comments, "The problem is the corporate culture of the firm that is also illustrated in other Japanese firms: Plethora of suppliers with ties difficult to untangle, seniority-based system. A state of 'satisfactory underperformance' until the financial crisis." Seniority-based promotions left little motivation to perform in the employees, decisions were taken by the few at top and the rest of the workforce including middle management had no role whatsoever to play in the decision-making process. The convoluted network of *keiretsu* cross shareholders brought together many stakeholders who are essentially other companies facing similar dilemmas. One big disadvantage of this is that there is an unwritten, unexpressed unwillingness to push for painful cuts due to the fear that they would get the same treatment. In the case of Nissan there was multiplicity of plants as well as platforms and the capacity utilization was much lesser than the industry standards.

Ghosn and his team also identified the upside of Nissan that would act as drivers to place Nissan in the top league once more and would dictate the direction of the revival strategy. Nissan had a number of strategic and technological advantages

NISSAN MOTORS

such as international presence and reach, a world leading manufacturing system, leading edge in selected technological fields along with the team from Renault.

Reviving Nissan

After a thorough study of Nissan, Ghosn came up with the revival plan, the Nissan Revival Plan (NRP), an ambitious strategy to bring back Nissan into profitability. Commenting about the NRP, Lasserre, observes, "The turnaround strategy was SURVIVAL. When Ghosn came with the Nissan Revival Plan, the company was really sick and technically bankrupt." The plan promises included achieving profitability, reducing debt, rationalizing the workforce, the number of plants and platforms, what not. The NRP involved direct participation of 200 people from Japan, USA and Europe. In total 2,000 ideas were assessed and 400 proposals were submitted to Executive Committee on which the Board of Directors made a final decision in October 1999. The NRP set specific targets such as returning to profitability by FY 2000, achieving or exceeding the operating margin of 4.5 percent by FY02 and reducing the net consolidated debt to less than 700 bn yen by FY02. In the NRP, there was no room left for any kind of doubt either in the targets to be achieved or in the process in which they were to be achieved.

Ghosn noticed that the Japanese were very good in their function but when they were put into Cross-Functional Teams (CFTs), the team did not do well. In order to break the ice the whole of NRP has been implemented through CFTs. In total nine cross-functional teams were constituted, each devoted to one of the following business areas: Business Development, Marketing and Sales, Purchasing, Manufacturing, Financial Management, R&D Product Phasing Out, Organization and Decision-making process. It is these cross-functional teams that have brought about most of the changes in the organization.

The secret of achieving the turnaround within a short span of two years is that Ghosn took steps to control cash drain at all the possible points. It was not a phased revival but a well planned plugging in all of the possible leaks. Says Gordon Wangers, President, AMCI a car

testing and evaluating agency based in USA, "Cut costs, focus on vehicles that have consumer appeal, not projects by engineers, for engineers; improve the dealer body." All the problem areas were addressed simultaneously; capacity utilization, retrenchment, launching new models, shutting down plants, repaying debt, transforming purchasing practices. The result—NRP targets were achieved a full year ahead. And in his May 9th presentation this year Ghosn proudly announced that Nissan had been revived and was on its way to become a great company. In FY01, Nissan made a profit of 331.1 bn yen with a consolidated operating margin of 7.9 percent way above its target of 4.5 percent. The net automotive debt at the end of FY01 is at 435 bn yen, again much below its set target of 700 bn yen.

Tightening the noose

The period between 1999 and 2002 has been that of great significance for Nissan. Life for and at Nissan has undergone a thorough overhaul on all aspects for the better. Lasserre identifies "leadership (Ghosn), commitment (to resign if objectives not achieved), teamwork (cross-functional teams and cross-companies teams), effective communication and clear goals" as the key drivers for Nissan's success.

Ghosn's reputation as 'Le cost killer' was only crystalized with the strategy he adopted at Nissan. Cost-cutting measures of Nissan have contributed greatly to the improved profits of Nissan. The single most important contributor was savings in purchasing costs. Both during 2000 and 2001 savings in purchasing costs have contributed greatly to the improvement in the operating margin of the company. For years now, the Japanese system of *keiretsu* has been the backbone of numerous business relationships and partnerships. At the same time its usefulness was never fully established. Through a series 'I scratch your back, you scratch mine' type relationships, there were a number of cross-holdings in Japan. This necessarily meant mass weaknesses across the system with nobody willing to break the chain.

Before Ghosn entered Nissan, purchasing was through its *keiretsu* partners and the costs were exorbitant.

Each supplier was assigned a *shukotan*, Nissan's term for a relationship manager. It was the *shukotan*, who negotiated the deal with the supplier and favors got in way of getting the best deal for the company. Ghosn decided to break the chain and the process of procurement in Nissan went in for a thorough overhaul. To the dismay of many of its suppliers who were getting complacent in a cozy and secure relationship with Nissan, the company started inviting global bids from suppliers. And the order would go to the supplier who would deliver a part faster and cheaper even if it were a European concern. This move pushed suppliers to give the best deal if they were to win Nissan's contract and also forced them to be more efficient to meet the global standards. Thus in molding itself Nissan has had a definite positive influence on the ancillary industries in Japan.

For Nissan, its cost reductions in purchasing costs are in tune or better than the targets under NRP. Purchasing costs have come down by 20 percent from pre-NRP levels. The total number of parts suppliers with whom Nissan deals has also come down by 40 percent to 700 from the pre-NRP figure of 1,145. The number of service suppliers who transact with Nissan have also come down by 70 percent. Nissan's cross-functional team of 300 engineers and purchasing controllers work with vendors on cost-saving ideas, which brought about a third of the total cost reductions. The team has received around 50,000 cost-cutting proposals from vendors.

Nissan also initiated rationalization of the distribution network in Japan. A total of 355 unprofitable and overlapping outlets, which accounted for more than 10 percent of the total points of sale in 1999 were closed down. The number of wholly-owned subsidiary dealers in Japan too were reduced by 20 percent to a total of 80 through merging of selective subsidiary dealers for more efficiency, by selling others to independent dealers or by management buyouts.

Closing the shutters

Nissan moved swiftly in severing non-core assets. This move not only brought in the necessary cash but also helped the company focus on its core activity of carmaking. Sale of non-core businesses has generated a total of more than 530 mn yen in cash in two years. The funds were mainly used to retire debt. The main non-core spin-offs include

The secret of achieving the turnaround within a short span of two years is that Ghosn took steps to control cash drain at all the possible points

former aerospace division, plastic fuel tanks and velocity joints etc. Major names include Ikeda Bussan to Johnson Controls, Ichikoh to Valeo, Yorozu to Tower, Vantec to 3i etc. The entire portfolio of marketable securities in Japan too was sold out.

Another area of chronic concern for Nissan was the sheer number and variety of its platforms and the multiplicity of its plants. Before the alliance with Renault, Nissan operated at 51 percent of capacity much lesser than the 70 percent, which is generally considered as the break-even point for auto plants. Not that the management did not realize this but the problem was that they did not dare to consider the option of closing down plants given the overriding societal concerns. But Ghosn would have none of this. In what might seem a brutal move for some, he went ahead and closed down five plants in manufacturing. The number of platforms too has been simplified. From a situation where seven plants produced cars based on 24 platforms at the beginning of the NRP, Nissan has moved to a stage where four plants in Japan produce cars based on 15 platforms. The execution of the plan was exemplary and at the end of the day there was no stoppage of production suffered by Nissan due to the transfer of people, equipment and machinery.

The opposition was strong. Managers at various Nissan affiliates 'could not think of closing down so many plants'. But Ghosn was not to be let down. He preached utilizing the plant at maximum capacity as well as being geographically close to the market so as to reduce the exposure to foreign exchange fluctuations.

Nissan closed its plant in Musashi Murayama, a Tokyo suburb. Most of the workers were offered jobs at other factories. Convincing the unions that closing down plants, though painful was in the interests of the workers and demanded some concessions by Ghosn. Ghosn accepted the union's demand to pay a one-time bonus worth 5.2 months' pay in the 'shunto'—the labor negotiations—held throughout Japan just before the closing down of plants was initiated. After the closure Nissan's capacity utilization improved dramatically to 75 percent from its erstwhile 51 percent.

Managing manpower

Cutting down the workforce was yet another important measure undertaken by Nissan. Many Japanese companies are burdened with more employees than was needed as the social system in Japan does not encourage retrenchments. There is an underlying understanding that big companies have a social responsibility in retaining the workforce. The fear of damaging their brand image has thus forced many a Japanese corporate major to carry on with the mammoth workforce. However, Ghosn moved swiftly and cut down the workforce to 125,100 from 148,000 in US. The reduction surpassed NRP's target of 127,000. Most of the retrenchment came with the spin-off of non-core businesses, increase in part-time and flextime employees, voluntary retirement and natural attrition. Analysts comment that this retrenchment was possible only because of the alliance with Renault. Nissan had to face some political hindrances in implementing this decision but stood firm.

Ghosn brought with him the ruthless business sense and an objective management craft to replace the relationship dominated business processes of Japan. He installed

Ghosn brought with him the ruthless business sense and an objective management craft to replace the relationship dominated business processes of Japan

orientation towards profit in the annals of Japanese industry. Ghosn soon noticed that the seniority based compensation system in Japan was a sure performance killer. There was no motivation to perform better or to give the best. Employees knew when and how their career would grow and they knew performance had nothing to do with it. Ghosn sought to

change this system once the company got back into profitability. As a result, Nissan's employees received bonus that ranged anywhere between 3 to 15 percent of their year's salary. For the first time people working at Nissan knew it pays to perform and come to see a noticeable gap between the good and bad performers.

There were many things that were to change under the aegis of Ghosn. Japan's strictly hierarchical set of management had to make way to younger and more reform-oriented generation. Young meant those 35-year-olds or 45-year-olds as against the 60-year-olds who were

"The turnaround strategy was SURVIVAL. When Ghosn came with the Nissan Revival Plan, the company was really sick and technically bankrupt."

*Philippe Lasserre,
Professor of Strategy and
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Insead Graduate Business School,
Singapore*

always the decision-making hubs in Japanese business. Even in the formation of the famous CFTs, members were not selected based on their seniority but on their fervor for reform. The promotion and recruitment processes at Nissan underwent a dramatic transformation under Ghosn.

In a stark contrast from the traditional Japanese promotion system, which weighs heavily towards seniority, Nissan today handpicks promising managers. Each month, Ghosn holds a meeting with Nissan's six executive vice-presidents, one overseas representative and senior vice-president for human resources. During the course of this meeting the officers nominate promising managers who are younger than 45. The managers thus chosen each month get priority promotions and training. Thus, formally grooming future leaders and managers for the company. The recruitment process too has undergone changes. For the first time in 2002, the number of outside mid-career hires are more than college recruits. While the number of mid-career managers is 400, college recruits are only 280. In spite of the antagonism this generates in the ranks, Nissan today believes that it has little choice in recruiting middle managers from outside.

Uplifting the fortunes

"There is no problem in a car company that good products could not solve."

— Carlos Ghosn

Those words echo an undeniable truth in the auto industry. Nissan's turnaround only emphasizes the magic of new brands in boosting the bottom line of an automobile company. One of the chronic problems of Nissan was that it was not selling the products preferred by younger generation and as such its

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showrooms attracted very few visitors. This would seem ironic about a company, which in the 1970s was noted for its hot racing cars and exclusive design and styling besides reliable performance. Nissan's share in its home market of Japan too fell sharply from 33.7 percent in 1972 to 17.8 percent by 2000.

In order to tackle the problem Ghosn wooed master designer Shiro Nakamura from rival Japanese firm, Isuzu. Nakamura's claim to fame was his VehiCROSS, Isuzu's SUV-car hybrid. His job in Nissan is rather challenging because Nissan has lined up around 28 models for launch between 2002 and 2004. A car is a statement of style and little wonder then that Nissan is using all the means available to it to improve on the style aspects of its cars. During the year 2001, it was a series of new product launches that helped Nissan make profits and in fact increase its market share in some geographical regions in spite of the all-pervading slowdown. In Japan, Nissan's new car, March, has positioned itself firmly as the preferred entry-level car attracting buyers from other brands too.

In America too, Nissan's new Altima, repositioned in terms of size, power, styling and overall performance has become a smashing hit. The new model was named North American Car of the Year, a first for any Japanese brand in January 2002. In the next month, the car was also awarded Canadian Car of the Year, thus establishing the brand of Nissan firmly in the US. Altima suddenly raised Nissan's attractiveness and the number of visitors who came to Nissan's showrooms increased. Not only that, there was an increase in the sales of other Nissan models such as Maxima and Sentra by 9 percent and 14.3 percent respectively. In addition to developing new models and designs, Nissan has spread its wings across the globe. Prior to the NRP, the dominant markets for Nissan were US and Japan but by 2002, other countries have contributed to more than 10 percent of its overseas sales.

Ghosn: The man, the mission, the alliance

Ghosn had a reputation of a turnaround expert for his stint at tire-maker Michelin and later Renault in Europe. But his stint at Nissan has been exemplary. When he came to Japan, he was considered a *gaijin*, the Japanese word for outsiders and there was severe resistance, but today he is one of the most respected businessmen in Japan. In fact he is so admired that there is

a proposal to start a comic series about him, which is a great compliment in a country where people of all age groups read comics. Philippe Lasserre maintains that his role is absolutely central to Nissan's turnaround. He further observes that Ghosn is resolute but culturally-sensitive, action-oriented, communicator 'say what you think and do what you say' person. Gordon Wangers, supports this argument when he says, "Ghosn is clearly the leading CEO in the automotive industry."

There are, however, people who are quick to point out that what Ghosn did at Nissan was nothing remarkable but what any sensible CEO would have done. However, they claim that his being a foreigner made his work easier and the resistance lesser. The real challenge for Ghosn some predict will be to stabilize the early success of Nissan. He has only one predecessor in the auto industry, Lee Iacocca, who turned around Chrysler Corp with the same vigor.

The success of Nissan and Renault offers important lessons to many a merged entity, given the rate of failure in auto companies' combinations. The auto industry in the 1990s has been the stage of several mega mergers and alliances but not one has had the success of Renault and Nissan. Wangers opines that the Nissan-Renault alliance is "An unexpected success. Lesson is: Put a powerful leader in charge and don't meddle. Let him work with existing management to straighten out the mess." Renault sent Ghosn and left him to implement all the strategies he had wanted to without any interference. In fact at one stage, Renault admitted that if it were not for the confidence of Ghosn it would never have bought a stake in Nissan in the first place.

This alliance stands apart from others not only for its success but also for the way it was structured. Renault bought 37 percent stake and later on raised it to 44 percent. Nissan had the right to buy 15 percent stake in Renault, which it has exercised already. No brands were wiped away, there was no forced integration of the companies, and no culture clashes. Lasserre points out that Nissan-Renault's success was because of their "good strategic fit, good complementarity, good pre-identification of synergies and mutual respect and trust." At the very beginning both the companies had decided to retain their distinct identities while bringing about the synergies in the deal. Renault pumped in funds that brought life back at Nissan as well as

"Renault-Nissan alliance is an unexpected success. Lesson is: Put a powerful leader in charge and don't meddle. Let him work with existing management to straighten out the mess."

*Gordon Wangers,
President,
AMCI*

brought in the cost-cutting strategies to Nissan. Today, Nissan is paying back in terms of the design and styling aspects for Renault cars.

Future perfect?

"Through NRP, we transformed a struggling company into a good company; through Nissan 180, we will transform a good company into a great company."

— Carlos Ghosn

Nissan 180 is yet another ambitious plan that bears the hallmark of Ghosn and which began on April 1, 2002. The plan itself is based on four pillars: Higher revenue, lesser costs, more quality and speed and synergies from the alliance with Renault. The number '1' in the plan represents Nissan's intention to sell additional 1 million units by the end of FY 04. The company aims to achieve this target with the blitz of new products; there are 28 of them slated for the next three years. Its plans include both geographical and segment-wise expansion to support this projected growth. The '8' represents the net profit margin that Nissan wants to achieve. The '0' represents the amount of net automotive debt that it wants to carry in its balance sheet. All the three goals seem plausible given the performance of Nissan in the last three years. At least in terms of achieving the profit margin and reducing the debt burden Nissan is well ahead on its way even in the year 2002. Wangers, maintains, "It seems a little ambitious to me; but why not, given how quickly their Revival Plan was executed."

In hindsight all the measures adopted by Nissan might seem to be sheer common sense but it needed an outsider, *gaijin*, Ghosn and it needed a Renault to support him. ■

D G Prasanna, Team Analyst

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FINANCIAL MARKETS

E-Trading

Changing dynamics

The e-brokers in 2001 lived the year running expensive platforms, anticipating Fed rate cuts, navigating in a weakening economy and recovering from events that literally rocked the world. The volatility in the stock market has fundamentally altered the dynamics of the online brokerage industry. Mirroring the dotcom shakeout, the Internet brokerage sector is heading for a shakeout of its own.

With the end of the bull market in early 2001, the enormous growth of online trading, particularly Internet-based trading of stocks and mutual funds which were spurred by the incredible bull market, dramatically slowed and then declined. A survey of leading full-service and discount online brokerage firms by Deloitte & Touche reveals that average activity in online accounts has declined 42 percent in 2001 as investors adopted a more conservative approach to their portfolios because of market volatility. With the economy slowing down, and retail investors turning cautious, online brokers are reassessing their business strategies. The bear market has driven online securities firms to change their business focus from generating trading volume to capturing longer-term investors. Today, online-only brokers such as E*Trade, Ameritrade and WebStreet Securities, that previously stressed on discount stock trading, have started offering a wide array of products and services ranging from mutual fund supermarkets to cash management accounts to bonds and annuities.

E-trading – A flashback

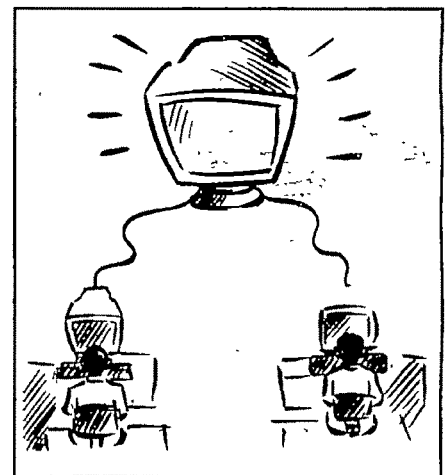
The roots of e-trading can be traced to the development of proprietary account access and trading software by Fidelity Investments, the mutual fund juggernaut and discount broker, in the late 1980s. This was soon followed by Charles Schwab's StreetSmart software, based on a Windows operating platform, which helped to increase the popularity of electronic account access and trading. Discount brokers, with their lean and no-frill operations, set the trend. Online trading acted as a catalyst to further reduce costs and improve efficiency. The rapid rise of the Internet and e-commerce, expanded the market reach

and made them boundless. As such, the industry is highly competitive with the large companies and the boutiques slugging it out for marketshare. The online discount industry consists of six large companies and numerous boutique brokerage firms that provide focused services to particular segments of the market. The six big players control almost 92 percent of the \$920 bn online volume and 80 percent of the online trading volume. The market leaders are a mixture of full service firms (DLJ Direct, Morgan Stanley Dean Witter, Discover), well-established discount brokers (Fidelity and Charles Schwab) and new online specialist firms (E*Trade).

According to SIA (Security Industry Association), the number of new online accounts continued to grow but much more slowly than in the past and the total value of assets in these accounts, hurt by falling equity prices, began to decline. Even the enormous share which online activity had captured in equity trading began to slide, falling from 27 percent in the second quarter of 2000 to 17 percent by the second quarter of 2001.

E-trading scenario in India

Compared to the Western counterparts, online stock trading is still in its infancy in India. In India ICICI Direct, KotakStreet, Sharekhan, MotilalOswal, IndiaBulls, InvestmartIndia, Geojit Securities and 5 Paisa are some of the major players. Of 1000 million population, we have approximately 5 million investors having Dmat account with depository, which clearly shows the penetration levels in India is quite low as compared to western market. Out of the total investing population 2,40,000 investors have registered for online trading with various brokers who are currently doing approximately 1.7 percent of the exchange turnover. In the US market 35



percent of the retail turnover comes from Net traders.

Currently on an average India has Rs. 40-45 crore turnover per day on Internet compared to exchange turnover of Rs. 2300 to Rs. 2500 crore per day on the NSE. Very few players are providing Net trading on BSE and the turnover is very negligible. Analyzing the pattern of the net turnover to total turnover, indicates that the ratio remained around 1.5 percent to 2 percent. However, due to limited volumes, no online brokerage is currently making money and a shakeout is imminent in the near future. The going is expected to get tougher with the advent of capital account convertibility. Players such as TD Waterhouse have already entered the Indian market, while others such as Schwab are expected shortly.

Changing business focus amidst volatile market

Just a year ago, with the bull market fueling active trading, the battle among most online firms was to acquire new online investors. Today, the e-broking industry is in doldrums. Brokerage

business is directly linked to the level of public enthusiasm for buying stocks. Ever since the tech stocks busted in 2000 online brokerage business has fallen sharply. Changing customer tendencies have altered the competitive landscape for online brokerage firms, who have changed their focus from generating trading volume to capturing longer-term investors with high-value accounts. Further with clientele growth slowing and trading volume sliding, the scenario has changed. Online trading firms are changing their business strategy. E*Trade, Ameritrade, TD Waterhouse, and Charles Schwab are scrambling to diversify their business models in order to find alternate sources of revenue. Thus, the big players are de-emphasizing the online-only channel in favor of a multi-channel, hybrid-model.

Because the economic downturn has driven many small retail customers away from online trading, e-brokerages are targeting HNWIs (Higher Net Worth Individuals) in order to survive in the downturn. Actually, HNWIs are those people with investable assets of at least \$1 mn, excluding real estate. Some 3.5 million US households are estimated to be worth \$1 mn or more, according to figures from the Affluent Market Institute. HNWIs in North America controlled \$9 tn in assets at the end of 2000, more than double the \$4.4 tn they had in 1996. Assets in the sector are likely to grow to more than \$13 tn by 2005. The players are expanding the range of services based on full-service model/one stop-shop.

According to Deloitte & Touche, online brokerages are changing their business models to provide investors with financial information and advice, quality customer service, an array of products, and innovative technology to gain competitive advantage. Also, the competition in online trading has led to an era of free or minimal-cost online trading. Now their focus has shifted to customer service, efficient execution of trades and the ancillary services. According to the report, the major factors that are changing the focus of e-broking business are increase in demand for quality customer service, professional support in investment-advisory as well as innovative technology.

The report elaborates that the discount firms are being forced to compete based on quality customer service and breadth of products rather than on just cost. Investors are more interested in professional support to manage the fluctuating market conditions now than they were a year ago. While 83 percent of full-service firms offer this client-consulting capability, only 31 percent of discount firms can provide the same. Today, discount firms are seeking to differentiate themselves from their full-service competitors by offering innovative technologies. A larger percentage of discounters, compared to full-service firms, offer wireless access, streaming quotes, and Electronic Communication Networks (ECNs). For example, 77 percent of the discount firms offer real-time streaming quotes compared with none of the full-service firms interviewed, and ECNs are available with 79 percent of discount firms, while only 33 percent of their full-service counterparts have this facility.

Fierce competition among players is likely to drive the industry towards consolidation. Stand-alone brokerages who will find the going tough in a competitive environment may be either wound up or be acquired by a stronger entity. For players such as Charles Schwab, E*Trade which has a wide retail network and aspires to be among the top two or three players in the retail brokerage business in the world, the "niche" model probably makes greater sense.

But how players are managing at the marketplace?

With broad declines in stock prices, investors are now looking for much more than low-cost trade.

A broad product range, reliable information and advice, and innovative technology have become the critical factors in choosing an online securities firm. Therefore, the players are seeking to help customers manage their assets, rather than simply compete on price. Some are looking for niches. Rather than focusing on one market, players are planning to offer customers the choice of a dozen Asian markets, as well as the US. Players have started offering a full range of investment products, including

"Transformation from a traditional-personal to a cybernetic-impersonal way of doing business takes time and this process can only evolve and mature during the course of time."

*Hemang Raja, Head,
www.investmartindia.com*

bonds, mutual funds and IPOs. Online leaders, including Schwab, E*Trade and Fidelity, diversified into banking and insurance services. These companies are also adding advanced financial-planning features, including retirement, budgeting, and debt reduction and college-planning software. And one thing that Charles Schwab and E*Trade has done to distinguish themselves is their attempt to become a one-stop financial supermarket. E*Trade through a string of acquisition now provides banking, insurance, mortgage lending, and other services in addition to its core business. Charles Schwab is concentrating on customer service and investment research. According to *BusinessWeek*, Schwab tops the list on research outfit Ameritrade is also expanding its personal-finance offerings but not as vigorously as E*Trade.

Schwab and Ameritrade are concentrating on attracting more active customers by acquiring direct access technology players CyBerCorp and TradeCast, respectively. Such trade-executing technology is popular among day traders and hedge fund managers who need to make quick trades. E*Trade, Ameritrade, and Schwab offer mutual fund services.

Online firms are also looking to forge strategic alliance to broaden their service. For example, E*Trade has been at the front of the move to broaden its services, adding Internet banking, ATMs and mortgage lending through its acquisition of loanDirect. Also the changed strategy among firms is evident in their advertising. They are now stressing on a broader range of services and products such as mutual funds, branches, wireless trading and banking services.

Stand-alone brokerages who will find the going tough in a competitive environment may be either wound up or be acquired by a stronger entity

They have also started differentiating by using latest technologies to woo the customers. Facilities like streaming quotes, wireless trading, account aggregation and direct access has been receiving the most attention.

Big players are also using data mining and business intelligence to customize offerings and trigger cross-selling. Charles Schwab is testing an automated service that monitors the activities of its affluent customers and flags accounts for e-mail offers on specialized financial products. Schwab is also piloting a customer retention program that uses data mining tools to identify affluent clients who are likely to leave the firm.

The keys to selling a wider range of products are customization, the capacity to analyze customer behavior and the ability to anticipate the full financial needs of individual customers. Market leaders are also expanding internationally with overseas licensing agreements, joint ventures and acquisitions. E*Trade's global strategy is to extend its brand to one country at a time by finding strategic brokerage partners like Japan's Softbank which are well placed to take advantage of the online market in their home countries. Charles Schwab and Waterhouse Securities are using partnerships and acquisitions to build bridgeheads in Australia, Canada, Hong Kong and the United Kingdom.

In order to protect the bottomline from becoming red Ameritrade, Charles Schwab and Datek have all cut jobs. Analysts generally agree that if Net brokerages have to cut costs to keep them in line with revenues, then trimming staff—and even server capacity in a time of low trading volume—is the way to go.

Primed for a shakeout

The downturn in the market has been a double whammy for the online brokerage firms. Like the dotcom shakeout, the Internet brokerage sector may be heading for a shakeout. There has been a dramatic drop in new accounts opened at online brokerages along with a dip in volumes. Today boosting the number of client accounts and the revenue per account is a matter of survival.

Firms are looking to acquisitions to drive their growth. According to Deplite & Touche there are roughly 140 online

brokerages, the top six accounts for 80 percent of online trading, while 15 firms account for 95 percent. Therefore, the smaller firms will be pushed out of the market unless they can settle into some niche segment not served fully by larger firms. Even larger firms that specialize in online trading without offering a range of other services could be acquisition targets. The cost containment, customer acquisition and revenue diversification are the major consolidation drivers of the e-brokerage industry.

The current market environment will compel brokerage firms and investment banks to seek out mergers with firms with less volatile, more stable, and predictable revenue streams, such as banks and insurance companies. As the economy wallows in a slump, transaction-based revenue companies like online brokerage firms will either merge or will be acquired. These companies suffer the most from decline in trading volumes and often lack a diversified revenue stream. Also the online firms can easily be integrated because of their similar infrastructure and business models. The acquisition of Web Street by E*trade in August 2001 was marked by the ease and short duration of the integration effort.

On a similar strategy Royal Bank acquired Dain Rauscher a regional retail broker/dealer and Charles Schwab acquired US Trust, a private bank trust company. Still acquisition targets are aplenty and strategic maneuvering drives the metamorphosis of the online brokerage industry. Recently Chase Manhattan Bank USA sold 33,000 of its high net worth deposit accounts (worth \$1.5 bn) to E*Trade.

The biggest threat to online brokerages comes not so much from each other as from large financial institutions like Citigroup and Wells Fargo that are beginning to move their businesses online. Basically online brokerages business depend upon brand name, technology, and customer base. And large financial institutions like Citigroup already have the technology and a brand name. The only reason a large institution would need to acquire an online brokerage would be to enlarge customers base. Further big banks could simply wait for some of these pure-plays to fall by the wayside and then pick up



their customers. Therefore, the analysts say E*Trade and Schwab's efforts to diversify their revenue could be construed, among other things, as defensive measures to ward off suitors.

Why has online trading not taken off as expected in India?

In a nation with a middle class population of 200 million, most of whom dream of a better, financially comfortable tomorrow, the stock market is obviously seen as the perfect place to invest. However, India's scam-scarred bourses haven't exactly inspired trust among retail investors. Online trading in the year 2000-2001 accounted for only Rs. 50,170 crore out of total traded volume of Rs. 25,08,445 crore.

Normally, online trading has succeeded in countries when the market was in a bull phase. Unfortunately, the time when online trading was launched in India coincided with the steep decline in the markets. Apart from the prevailing bear market, the other major issue has been awareness and the mental acceptability factor. Internet-based trading typically takes place through a bank account with an online bank. The relative inability of large public sector banks to offer facilities for Internet banking is a barrier in this regard. Besides, Internet penetration in India is still very low and concerns about security also predominate. In markets like the US, online brokerages advertise very heavily. Online trading in India has so far not seen similar levels of aggressive advertising, with the exception of ICICI Direct.

According to HemangRaja, Head, www.investmartindia.com, Consumer expectation, infrastructure, physiological barriers and lack of education of the medium are the main factors, which has hindered its growth. He says, e-broking

The keys to selling a wider range of products are customization, the capacity to analyze customer behavior and the ability to anticipate the full financial needs of individual customers

E-TRADING

was introduced in India at a time when Internet boom was at its peak and like other businesses on the Net, there was a general perception that e-broking will change the way broking business is done. However, the fact is, transformation from a traditional-personal to a cybernetic-impersonal way of doing business takes time and this process can only evolve and mature during the course of time. He says the Indian investor prefers personal interaction. This makes him feel safe and re-assuring. Absence of a strong customer relationship management system makes the alternative medium too impersonal and is making this transition slow.

According to Hemang Raja, the main problem faced by e-broking players in India today is lack of investor awareness/education. He elaborated that in our country, the Net needs to be demystified and expanded. Investor education plays a vital role in this context to create the awareness levels to mitigate the concerns that shroud his psyche.

Also, the breadth of participation in the stock market in India is significantly lower as compared to Western markets with only 12.1 million equity-owning households and three million depository accounts. Brokerage rates in India are significantly lower than US rates, with Indian brokers charging commissions of 0.85 percent to 1.25 percent per trade.

Even technology bottlenecks are responsible for online trading not taking off the ground. India's banking, broking and depository platforms, though all linked to the same trade, function on entirely different platforms. Integration of these three is a major technology obstacle. The three main technology obstacles which have prevented Internet broking from taking off are lack of Internet penetration, bandwidth infrastructure and poor quality of ISP infrastructure. On infrastructure bottlenecks, Hemang Raja opines, "the experience of previous year reveals that the expectation of Net trading is encompassed to speed and current state of bandwidth quality and availability constitutes a significant impediment to e-broking."

One of the major barriers to attracting new customers to online financial services is the issue of privacy and security of financial information that is transmitted

over the Internet. Incidents of hacking in some websites (including E*Trade) in recent times underscore the need for taking appropriate measures to protect investor confidence. Companies need to put in place state-of-the-art encryption and authentication technologies, which protect investor transactions with multiple layers of security so that they can trade or bank online with confidence. Managing financial risks will become more important to protect consumers and investors.

Commenting on the Indian security issues, he says "Authentication, privacy, integrity are the major challenges confronting the e-broking industry in India." He addressed security levels at the brokers sites and also in the banking and settlement sector that are essential and underscored the importance of user details confidentiality for the retail investor. With reports of security breaches taking place in established brokerages overseas, customers are a little shaky of the security levels in online trading. These doubts can be laid to rest only after cyber laws become effective and more advanced security systems are available.

The market for online financial services is getting increasingly competitive. In order to create and sustain leadership in this space, companies would need to differentiate themselves from the crowd. As the basic offerings are easily replicable the key differentiators would be customer care. Customer care is the

ability to maximize client satisfaction at the lowest possible costs while maximizing the gathering of useful market intelligence data. The key issue areas in ensuring customer satisfaction are developing processes that help resolve customer queries in the first contact and ensuring the most convenient access for the client.

Commenting on the future prospects he says, "the first phase has been wobbly and more of a trial and error. I am sure most of the participants are evolving each day to adapt themselves to the investor preferences, technology challenges, infrastructure bottlenecks that one faces as one moves along. In this first wave of investor experiences, we have been able to attract a mix of young savvy investors and the experienced older ones. These are market

savvy participants and are adapting to the net platform naturally. The challenge lies in market expansion through application of relationship management tools that seamlessly integrate with the traditional model to offer investors a more wholesome investing experience."

Conclusion

Occasional crashing of trading systems; slowdowns and erratic system behavior continue to plague the online brokerage industry as it struggles to manage fluctuating fortunes. If players try to migrate to a full-service model, they risk going too far—forgetting what was initially attractive about the online trading business model. The strategy to convert one-service model to full service model can backfire. There are several players now in the fray, and few with domain expertise, which is very vital for success. Online brokers who have a better chance of survival may, therefore, either be the ones which become either niche players who offer highly specialized products or cater to the whims of day traders, or diversify to become online supermarkets.

Over the next year or so, the competitive advantage for online stock trading brokers is expected to be a combination of technology, content and customer service. While technology can prove to be a major entry barrier in an online trading venture, customer service is likely to be the key differentiator in the initial stages as a client attempts to learn the fundamentals of online trading.

Unlike the US markets e-broking is far from reaching its critical mass in India. Online stock trading in India is still at a nascent stage, practically all the major players who have set-up the e-broking outfits are aiming to broad base the overall trading base of investors in the country, while retaining their existing client base. Customer acquisition is turning out to be an uphill task in this bear phase. One of the major barriers to attracting new customers to online financial services in India is the issue of privacy and security of financial information that is transmitted over the Internet. Among other major issues which are hindering its growth prospects is the lack of awareness and the mental acceptability factor. Consumer awareness is at a very low level, and brokers also have not been forthcoming in accepting that Internet trading shakeout is imminent in the near future. ■

Rajesh Kumar Singh, Team Analyst

Reference # 1-2002-07-10

The competitive advantage for online stock trading brokers is expected to be a combination of technology, content and customer service

FINANCIAL MARKETS

Wall Street Firms

Thinning veneer of credibility

The New York Attorney General Eliot Spitzer has stirred a hornets' nest with the latest round of accusations against Merrill Lynch's and its competitors including Goldman Sachs Group Inc. and Morgan Stanley Dean Witter & Co. The highly paid investment bankers who were once treated as demigods are now on the danger list.

The glitz of the bygone era turns the investment bankers' nostalgic. Morgan Stanley's Mary Meeker, anointed by Barron's as the "Queen of the Net" Jack Grubman, Citigroup's telecom analyst, who at about \$20 million per annum was the highest paid analyst ever, and the likes of them have all witnessed a fall from dizzying heights with the burst of the Internet bubble as well as the telecom debacle. With New York Attorney General Eliot Spitzer, launching a trade of accusations on Merrill Lynch, buried secrets have surfaced and are creating ripples across the Wall Street.

Conflict of interests

An investment bank provides its corporate client with commercial banking services, it supplies merger advices and acts as an underwriter for the company's securities. Its fund management arm purchases those securities, the bank along the line also becomes the counter party in structured finance for the company that it helped design, it manages its commercial paper plans and also carries out foreign exchange transactions for the company. Conflicts of interests are bound to arise as these activities are carried out in the same place and get enmeshed with each other.

In the late 1920s, when the bull market was going strong, Goldman Sachs created close-ended investment trust that invested in a number of other trusts. Goldman was the sponsor, manager and the salesman of the trust. Along with this it was also the pre-initial public offering investor. Goldman Sachs thus had conflicts of interest. It sold 90 percent of the shares to the public at \$104 each. The price fell to \$1.75 after 1929 crash. At the very same time National City Bank was also entrapped in a number of conflicts of interests, such as insider trading and the sale of bonds, which it knew, were worth not even a dime. Consequently, Glass Steagall Act was introduced to separate investment banking from corporate banking.

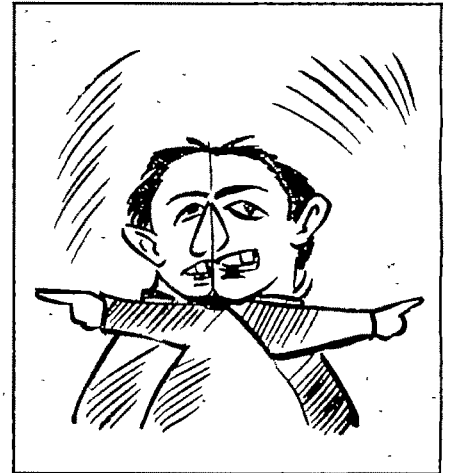
However with the Glass Steagall Act scrapped in 1999, Citigroup the modern day form of National City Bank, is permitted to do investment as well as commercial banking together. There are conflicts galore between both the roles. Or, one hand investment bankers such as Citigroup seek hefty revenues as a result of offering advise on mergers and on the other, they assure the corporates that they will support the deal with a lump sum loan. If the deal is a success investment bankers are able to get their fees, but the commercial banking is left to retain the loan and the credit risks that arise from it. Sometimes such conflicts break out in the open. Only recently, Walter Hewlett, the dissident Hewlett-Packard shareholder, went to the court and argued that Deutsche Bank casted its vote in favor of HP-Compaq merger for it had a number of other businesses with the company. Though the court did not listen to such claims yet they portray the labyrinth of relationships between clients and the investment bank.

Wall Street firms are known to reap huge fees and bonuses by persuading clients to do deals, for no deals means no fee. Therefore, Wall Street shows a green signal to all kinds of transactions whether good or bad.

The IPO market: Thunderstruck

It is no longer a secret that investment banks attract young start-ups with the lucre of Initial Public Offerings (IPOs). Rather than raising the maximum money possible for the side they are supposed to represent (the issuer paying a fat fee), investment firms use their IPO game to curry favor with their other major clients, such as the institutional investors. To be more succinct, they ply mutual and hedge funds with artificially cheap shares from the offering and then get repaid in high commission stock trades.

The investment banks have failed to raise money for the corporates. Instead of



serving their corporate clients they might actually be harming them by raising money at exorbitant costs. The banks price their clients' shares far below their full market price (which can be taken as the price they touch on the first trading day). In fact, on an average the first day offering prices jumped 71 percent in 1999 and 57 percent in 2000 as compared with an average of 11 percent from 1980 to 1998. Wall Street gives the under priced shares to the group of institutional investors that trade with it, in turn most of these buyers sell their shares for huge gains. In this way the money that should have flown to the corporate clients fill the pockets of the favored funds and other preferred clients. This precedent reached such orgiastic proportions that for each dollar that corporate America raised, it paid an incredible 57 cents in fees and foregone proceeds.

It is true that investment bankers can earn higher fees by pricing the shares to greater levels i.e., closer to their opening levels, however the greater truth lies in the fact that trading revenues can far exceed the fees left on the table. During 1999 and 2000, the firms typically allocated their 80 percent of the offerings to about 125 funds. Cheap IPOs came as a

boon for Wall Street. In some cases, management of the concerned firm is cajoled into doing business with the investment bank firm by promising them "friends of Frank" accounts. These accounts derived their name from Frank Quattrone, an investment banker with CSFB (Credit Suisse First Boston), and were given to the managers who agreed to hire CSFB as their investment banker. Through these accounts the company officials received preferential allotment to the shares in IPOs. A way out to the same could be full disclosure to the relationships between the company officials and the investment bankers they deal with. Some economists have suggested even more radical moves such as ban on dealings between the managers of a company and the underwriters for at least a couple of years after the company goes public. In fact, CSFB paid \$100 mn to settle an investigation which was all set to unearth its practice of allocating shares in IPOs to favored clients who repaid a part of profits that they made as a result of conducting the unnecessary trade with the broker.

The investors are also concerned about the fact that they never get an opportunity to purchase shares in the initial distribution and they end up buying the shares at astronomical mark-up in the after-market to participate in IPO. Probably a solution would be that investment banks use auctions to allocate shares of the IPOs to the highest bidder.

There are speculations rife that the next spate of lawsuits against the Wall Street firms will target the underpricing of IPOs, especially in the face of the recent suit filed by eToys against Goldman Sachs. eToys is claiming that it was deprived of the money that could have helped it sustain the hardships of the present recession, had the investment

Merrill Lynch: Still Going Strong!

In spite of the recent allegations that analysts at Merrill, recommended the stocks that they personally scorned, Merrill Lynch and Co. Inc.'s stock research arm remains one of the most read by fund managers. However, its competitor Morgan Stanley has overtaken it in terms of individual analysts' ranking. The results from a 2001 and first-quarter 2002 survey by market research firm Thomson First Call prove that size matters when it comes to attracting the attention of fund managers. In fact, Merrill has one of the largest research departments in Wall Street; however the size may not matter much in holding the attention of asset managers for long.

According to some, the data suggests that pound-for-pound, Morgan's analysts' experience level and background are at higher levels than that of Merrill. Eight of the top ten most read analysts in 2001 were from Morgan Stanley. According to the fund managers the massive research staff of Merrill Lynch helps it attract the maximum attention of fund managers.

Five Brokerage Firms Most-Read in North America (Quarter 1, 2002) are:
Merrill Lynch; Salomon Smith Barney; Morgan Stanley; Goldman Sachs; and JP Morgan.

bank not under priced its issue in order to receive money in the form of commission from the sectors they allocated the shares to. Considering the fact that the total IPO under pricing during the years 1999-2000 was to the tune of \$66 bn, the payouts in such cases can be very high.

Playing the Pied Piper

Eliot Spitzer, New York Attorney General who has been in the news of late, built his case largely on the e-mails submitted upon request by Merrill Lynch. As per these mails, one of the analysts wrote that, "The whole idea that we are independent from banking is a big lie." Even when the analysts, led by Henry Blodget at Merrill believed that the company had no spark they continued to recommend its shares. According to some of the internal e-mails, the shares of *excite@home*, rated as short-term accumulate and long-term buy, were described in Internet e-mails by one Merrill Internet analyst as "such a piece of crap". Expressing his opinion on GoTo.com (long-term buy), Blodget said nothing was interesting except the "banking fees".

The "so called" independent analysts, working behind the Chinese walls are paid exorbitant sums not for the credibility of the advice that they provide the investors with, but for helping to secure corporate finance deals from the companies that fall under their purview of analysis. According to Satyam K Agarwal, Research Analyst, Khandwala Securities Limited, Mumbai, "Wide scale abuse of the basic operating norms in this industry, be it the "Chinese Wall", or "strategic" disclosures to specific interest groups have led to this steep dive in faith

and confidence. He further adds "to remove this decline in faith would take a very long time and hard-to-instill efforts, to say the least.

In fact, there have been instances when analysts have been asked to call it a day when they have issued a sell recommendation or taken steps that are not in the interest of the bank's clients. In a number of cases the salaries of the analysts are linked to how much corporate finance deals such as advice on merger acquisitions cases, IPOs they bring. It comes as no surprise that the analysts' advice became positive across the board. Corporate finance is the most paying part of investment banking; therefore the temptation to forego analytical credibility is egregiously strong.

For Merrill, retail base is the lifeblood of business, and these charges sound warning bells. The firm has been careful not to admit any liability. They decided that it was more apt to go for an out-of-court settlement. They agreed to pay a fine of \$100 mn and accept changes in its organization and its methods of paying the analysts. This is fairly an easy way out for the investment bank. The settlement is unsatisfactory in several ways. Firstly, Merrill Lynch is a global investment bank, it has investors spread out across the globe who have suffered financial losses, therefore why should only the New York State coffers be filled with the 50 percent of the aforesaid amount and the rest of the amount divided among the remaining states? Since the establishment of the Securities and Exchange Commission, the securities regulation has

"There has to be an impervious Chinese Wall between Research and Investment Banking interests in any investor conscious entity in the financial services segment."

*Satyam K Agarwal,
Research Analyst,
Khandwala Securities Limited,
Mumbai*

WALL STREET FIRMS

become a federal matter and before Spitzer proceeds to check out on other firms such as Morgan Stanley and Citigroup, SEC must take the case in its fold.

The second flaw that is imminent is that even though it is a good step to sever the link between analysts' pay from investment banking and monitor closely the links between analysts and bankers, this step in itself is not sufficient to remove the conflicts of interests between analysts and investment bankers. One alternative is to impose strict internal controls. Analysts should be punished to take part in the capital raising process. However, all of us are acquiescent of the fact that Chinese walls have become mere artifacts as long as investment bankers and analysts work under the same roof. One possible way out is to re-establish structural separation. Perhaps there could be a split in research and the investment banking activities, which will be similar to Glass Steagall Act that called for a ban on investment and commercial banking being carried within a same firm after the 1929 Wall Street crash. There are chances that a split might bring an end to the practice of publishing over bullish research reports designed to win investment-banking business from the corporate world. However, the effect of this move will have to be analyzed in the light of the many other factors. Regulators will have to mull over taking possible steps such as putting an end to indirect commissions, splitting brokerage and research and the required changes in the IPO allocations. According to Akhlesh Eaveja, Deputy Manager, UTI

Investment Banks: The New Act

Amidst the recent spate of charges made by the New York State Attorney General, Eliot Spitzer, Lehman is coming up with certain changes. It is trying to avoid the charges, which alleged that the Wall Street firms hold views, which are too optimistic. The new system will be effective from August 1, 2002. It will rate the stocks, "overweight", "equal-weight" and "underweight". This will replace the current five-tier system. The equities will now be compared with specific industries instead of the broad market. Morgan Stanley Dean Witter & Co. had started implementing the same system from February 2002. The change is also based on the feedback the Lehman officials have received from their institutional clients and their sales organization.

The other major investment bank, Citigroup Inc.'s Salomon Smith Barney, has also indicated that it might adopt the method Morgan Stanley has come up with for stock rating. It is noteworthy that when Morgan Stanley had put the system in place, its analysts downgraded 22 percent of the companies to their lowest rating with immediate effect. This figure earlier stood at just one percent.

Investment Advisory Services Limited, "To set the markets right, more fire walls between the various conflicting businesses are required, there should be proper guidelines and code of ethics set for professionals and there is certainly a need for more disclosures."

Caveat emptor: Buyers beware

There is no doubt that the Wall Street investors receive a lot of wrong advice, however the investors must not forget that all the advice comes wrapped in caveats. They must never forget that one of the oldest rules of the markets: "Buyers Beware" is true in these cases too.

Investors must rely more on their own awareness of the potential conflicts visible on the horizon. They must not take the above proceedings as a pretext to free themselves of all the blame for the

bubble. These can lead them to believe falsely that somebody else apart from them was responsible for the fiasco and they should be monetarily compensated. The need of the hour is not to run after lawyers who will fight their cases, a better option will be to grasp the true fundamentals of the market in a better manner. They should understand that when it comes to the prices of shares they face a lot of uncertainty. It should be clear to them that the companies flocking the markets hold a lot of potential risks and they must not follow anybody's advice blindly, whether it is their bankers, analysts, or the media.

It is better for investors to spread their risks and go in for investing through mutual funds, otherwise they stand to lose their money.

As far as the markets are concerned they are formulating their own verdict. Fund managers have come to rely more on their own research and are in the process of building their own teams. Regulators have also been forced to stand on their feet and take a hard look at the so called soft commission which form the kickbacks given by firms to the investment bankers in return for positive coverage of the concerned companies. There is no doubt to the fact that the recent spate of reforms has led to exploration of various possibilities such as severing research department from investment banks and better prospects for independent research firms in future ■

Related Article:

- 1 Wall Street Analysts Under Scrutiny, *Analyst*, October 2001

Aparna Mehta, Team Analyst

Martin Act: Creating Ripples

Eliot Spitzer is wielding a powerful weapon, a state law called the Martin Act, put on the books in 1921 to curb fraudulent investment advice. The Martin Act is an 80-year-old state law that gives authority a right to investigate and prosecute brokerages and calls for civil and criminal penalties. Authorities using the law do not have to prove that perpetrators wilfully did something illegal, which the federal law requires. It deals with securities markets, and has tough provisions about fraud and deception. The stock analysts and their activities have proved to be noteworthy fodder for the use of the Act.

Spitzer's use of the Martin Act to try to wring concessions from Merrill Lynch is the first time in memory that the law has been used against such a high profile company. Some observers say he's upstaging the Securities and Exchange Commission, which has a federal mandate to oversee the securities industry. Usually, New York prosecutors use the law to break up schemes such as "boiler room" telemarketing firms that make cold calls trying to sell stock or mortgages. Officials in other states use their laws for similar purposes, aiming to prevent a wide variety of small-scale investment fraud. They generally use this law to tackle cases that fall beneath the purview of SEC.

Reference # 1-2002-07-11



Admission Notice

The Fellowship Program in Management

Leading to the award of PhD Degree

3 Year Full-time Program (2002-05)

The Institute of Chartered Financial Analysts of India (ICFAI) has set up the ICFAI Institute for Management Teachers (IIMT) at Hyderabad. IIMT fulfills a longstanding need for equipping professionals with the knowledge and skills required to become effective management teachers and researchers. In this context, IIMT is happy to launch the Fellowship Program in Management (FPM) leading to the award of PhD Degree.

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 - First Year : Rs.12,000 per month
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CORPORATE FINANCE

Convertible Bonds

Heading for the worse?

Conventional wisdom holds that convertible bonds are a reliable option during times of economic uncertainty. However, with the downward spiral in the stock markets across the globe, issuers of convertibles are now finding themselves in deep trouble.

During the bull run of the 1990s, more companies than ever before issued convertible bonds never thinking that they have to make payments back to their investors. Buoyed by the rising stock prices, convertible bonds a.k.a convertibles provided companies a cheap option of borrowing money. Companies such as Lucent Technologies, WorldCom and Tyco International, capitalized on the newfound favor for these instruments by issuing large volumes of convertibles. However, with the downward spiral in the stock markets across the globe, these issuers of convertibles are now finding themselves in deep trouble. The enticing option of converting the bonds into equity apparently has now become a losing proposition. Further, a deeper problem is that most of their convertibles have come due and they have to repay billions of dollars to bondholders. Caught by surprise, these issuers are groping for ways to raise such huge amounts of money in order not to default on their commitments.

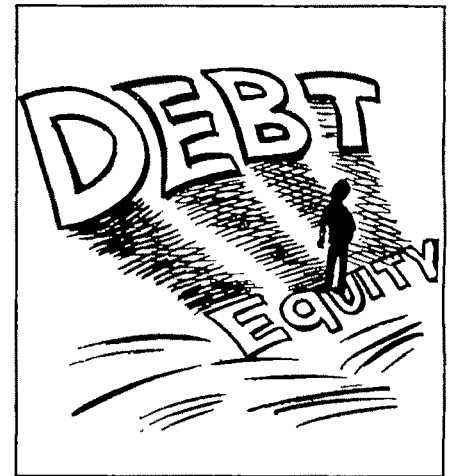
The bitter experience

Converts, as they are known in the trade, can be traded for stock at the predetermined exchange rate. When a company's stock rises, the corresponding convertible trades close to the price of the underlying equity. Companies, whose stock prices are buoyant, issue converts in the belief that investors would convert them to equity at an attractive conversion price. However, any slide in the stock prices prompts investors to force the companies to buy the bonds back at their original value. Further, if the company's stock declines to a price where the convertible feature of the bond is worthless, the bond will trade based on its yield—like any other bond as long as the company is solvent. Yes, there is a price level to which a bond will fall and fall no further as long as the company can pay its

interest and the principal upon maturity. And, it means big trouble for the already beleaguered issuers. So, where did the problem start?

Conventional wisdom holds that convertible bonds are a reliable option during times of economic uncertainty. Over the years they have been growing on this pretext—their dual nature and the inherent benefits associated with it. But with profitability concerns and accounting scandals, even these safe havens have lost favor. More than companies' performance concerns, the nature of issuance is to be blamed for this disenchantment with convertibles. Quantity and not quality of the convertibles had been the tenet for high-flying issuers. Over the past few years, troubled companies like Enron, Global Crossing, and Tyco, issued them as a last resort as they were unable to obtain bank loans, equity financing or even short-term debt. Ro Bawa of Deutsche Bank agrees, "For speculative grade companies that cannot access the equity markets, convertibles become the vehicle of last resort as it is a purely hedge-able instrument for investors. Also, big investment grade issuers that pay very small (often zero) coupons and substitute the convertible for their commercial paper program. Largely companies that want quick access to capital while their stocks are at or near highs sell convertibles at a large premium."

Whatever reasons they issued them for, convertibles fueled their already big debt troubles. Tyco International, the world's largest fire and safety instruments manufacturer, for instance, is one of the companies faced with the worst of troubles with its convertible bonds. Recently, its stock price plummeted due to accounting malpractices akin to Enron's. It issued convertible bonds in 2000 and 2001. In both these issuances, Tyco promised to



buy-back the bonds at certain prices if the bonds cannot be converted. Presently, the company's stock price is far below the price that would make conversion a better proposition and thus, its convertible bond prices are far below the pre-specified buy-back prices. The company has to stick to its commitments and honor its promises made to the investors. While any rational company would be cautious enough not to issue more and more debt and concentrate efforts on boosting business efficiency, Tyco did the former, it issued debt after debt.

The embattled company had issued about \$7.7 bn in convertibles and has to repay nearly \$6 bn in convertibles. To recoup, the company is planning to repay its two convertible payments due February 2003 (of \$2.3 bn), in stock because the chances of raising cash were washed out when its credit rating slipped. But Tyco's investors, who would not want their shares diluted during a stock slump, may not accept such a move. George Dessing, Vice-President, Corporate Treasurer of the Netherlands-based Wolters Kluwer NV, provides some relief when he says, "The dilutive effect of the issue of the convertible bond

CoCo: A Savior Turned Sore

Tyco's stint with debt is all sore. Soon after its convert issue in 2000, Tyco, the company mired in debt, invented the so-called contingent convertible bonds or CoCos. CoCos are a relatively new variety of convertible bonds; they can't be converted into stock until the share price hits a certain level. Most CoCos come with a put option that allows bondholders to sell them back to the issuing company at a future date, which could sometimes be as early as one or two years. The put options, in most cases, allow investors to sell the bonds back for more than the price they bought them for.

Tyco converts come with a contingent conversion, or "CoCo" clause, wherein the switch is possible only when the stock surpasses the conversion point by 10 percent. It lets the company exclude the unconverted shares from fully diluted EPS, because of the contingent clause to conversion. CoCos account for about 45 percent of Tyco's convertible issue. The company's issue was a \$3.5 bn zero-coupon convert having a yield of 1.5 percent and with 36 percent conversion premium (the price at which the bond may be converted to equity minus the current stock price). The bonds reached their first put date on November 17, 2001, about a month after the company announced its intent to use cash to pay off bondholders that chose to put back the notes to the company. Tyco paid the \$10 mn worth of CoCos that were redeemed in cash. The CoCos afforded Tyco little financial flexibility, other than to react to the bondholders' decision. The rest of the payments are not due until this year's end.

Sure, CoCos are innovative; if the underlying stock price of issuers falls with the market, bondholders may exercise the bond's put option. But, during a recession, investors may force issuers to pay them off before maturity. The issuing company would then have to raise new capital for the redemption. Just what Tyco faced. Its plain converts and CoCos, both of which were means of raising cash, actually stripped it of cash when it had to redeem the bonds.

will be offset by, inter alia, cost savings arising from the fact that the interest expense arising under the bond is less than under current indebtedness which the issue proceeds will be used to repay."

That's not all; Tyco has a \$1.5 bn bank loan and \$1 bn of bonds maturing this year. Next February (2003), a \$3.9 bn bank loan comes due and holders of \$2.3 bn in convertible bonds are likely to use the option to sell them back to the company. Also, holders of another \$750 mn of bonds and \$3.6 bn of convertible bonds are also likely to use a similar option. Further, another \$1.1 bn of bonds also mature that year. In a bid to clear the quandary, Tyco International Ltd. decided to separate itself into four independent, publicly traded companies, which it later shelved. To put to rest investors' worries, Tyco has recently reiterated that it has enough money to meet the bond payments through February.

Unfortunately, Tyco isn't alone in its convertible problems. Cox Enterprises, the majority investor in Cox Communications, was faced with a deluge of converts being put back. Around \$454.5 mn worth of a convertible issue (amounting to some 99 percent of the outstanding bonds) were put back to it, in February 2002. It had agreed to a special 1.7 percent payment to investors in the zero-coupon convertibles it issued last year instead of paying the full amount owed to its investors—mostly hedge

funds. Cox only spent about \$13 mn for this special payment. Otherwise it would have had to repay all of the \$545 mn it owed its bondholders. Cox also paid extra cash to investors who continued to hold the bonds beyond the put date. Comcast, the satellite communications company, also had to make a similar arrangement with its investors in December 2001.

Perils of too much greed

It is not that these problems couldn't have been foreseen. Companies, in their eagerness to raise cheap and easy money, went too far. Companies have used all the tricks in the book to profit from converts, giving rise to the likes of zero-coupon varieties of the debt instrument. For instance, in zero-coupon bonds, companies don't pay yearly interest. Instead they sell the bond at a discount that approximates the amount they would have to pay as interest till maturity. This way they enjoy tax benefits because they account for the interest yearly in their books and at the same time create demand for the bonds because of the deep discount. Again, there are arrogant or shrewd companies like Stilwell Financial, which issued its zero-coupon converts in April 2001, structured in such a way that if its stock doesn't rise appreciably over the next one year, investors could put the convert back to company, or in other words ask for repayment. In April, Stilwell paid an

amount close to \$697 mn as its stock has fallen by 20 percent since its convert issue through cash and some credit. Marriott Hotels also offered a similar proposition and because its stock has fallen by 19 percent since it issued its convert in April 2001, it had to pay about \$411 mn in May this year. Unlike Tyco, Stilwell and Marriott were fortunate to have cash in hand for the repayment.

There are still other companies, which are fueling the blaze. Calpine, for instance, issued and sold about \$1 bn new convertible debt in December 2001, in order to buy-back some of converts which got put back in April. And, who knows what they will do to repay these newly issued convertibles. Moreover, when the company issues more stock rather than paying cash, shares will flood the market only to depress their prices further, getting the problem back to where it started.

Many companies have also allowed investors to put back their bonds at specified dates so as to reduce investor's risk. This may not be a threat if interest rates don't rise significantly in the short-term. But if many investors put these bonds back after rates have risen, companies that need to raise new capital would find it more expensive. And poor performers might not be able to do it. ■

C S V Ratna, Team Analyst

Reference # 1-2002-07-12

FINANCIAL SERVICES

Indian Bank

Survival is not enough

The besieged Indian bank, which had been accumulating losses from 1993-99, is showing signs of a turnaround with the Government of India playing a major role in its recovery. Can the bank continue its run in the profit zone in future?

The Chennai-based Indian Bank, which in 1995-96 declared losses to the tune of Rs. 1336 crore, thanks to ever-rising non-performing assets, is after a series of rigorous restructuring exercises, back on track by posting a net profit of Rs. 33.22 crore for the financial year 2001-02. Even though a net profit of Rs. 33.22 crore is not a splendid performance by a bank with a deposit base of Rs. 24,000 crore, it is appreciable, for the bank was in the red for six long years and was facing considerable difficulties against any plan for restructuring. Moreover, for a bank that declared a net loss of Rs. 274 crore in the previous year, this is good performance and has definitely reinforced confidence of the 1.5 crore customers in the bank.

Consistent support from the Government in the form of infusion of funds totaling Rs. 3150 crore to the bank has helped it to survive, underscoring that adequate support from the Government is a prerequisite for weak public sector banks to return to profitability. Further infusion of funds amounting to Rs. 770 crore is expected to reach the bank by the year-end. The bank, which has a tag of 'weak and sick bank', has managed to turnaround, particularly after Ranjana Kumar took over the reins of the bank in 2000. As per the restructuring plan taken up in April 2000, the bank had to make net profit by 2002-03, which had been met by a year in advance. So, what are the reasons behind the turnaround of a bank for which making profits seemed like a human trying to touch the sky?

Improved performance

The restructuring efforts by the bank management have really paid off as the bank made a net profit after a gap of six years. The bank has posted an operating profit of Rs. 307.15 crore, which is an increase of nearly 399 percent as against the growth rate of 158 percent recorded

last year (in 2001, the operating profit was Rs. 61.59 crore). The gross income of the bank for 2001-02 is Rs. 2795.86 crore as against Rs. 2416.50 crore in the previous year showing an increase of 15.70 percent. The gross expenditure of the bank was Rs. 2488.71 crore in 2001-02 as against Rs. 2,354.91 crore in the previous year showing an increase of 5.68 percent. The business of the bank grew by Rs. 3686 crore to Rs. 36,222 crore. The business per employee is presently Rs. 156 lakh.

On the NPA front, the net domestic NPA fell to 8.54 percent of net advances as on 31.3.2002 from 10.34 percent for 31.3.2001. In absolute terms, the NPA was reduced by Rs. 562 crore last year and the cash recovery was Rs. 275 crore. In the last two years alone, the bank has managed to recover Rs. 1082 crore compared to Rs. 193 crore that was recorded between 1998-2000. Indian Bank has topped the list among all public sector banks in 'increase in interest spreads' (the difference between 'interest earned' and 'interest expended'). This in a scenario, where the entire banking sector has witnessed a squeeze in interest spreads. In the four-year period between 1997-98 and 2000-01, Indian Bank achieved a 340 percent increase in interest spread, from Rs. 111 crore to Rs. 489 crore—a performance bettered only by the ICICI Bank (453 percent increase) and the HDFC Bank (393 percent). The gross domestic credit has increased by Rs. 1047 crore or 11.22 percent during 2001-02 to Rs. 10,379 crore from Rs. 9332 crore and global credit stood at Rs. 10,908 crore. The aggregate domestic deposits of the bank grew during 2001-2002 by 12.18 percent (Rs. 2460 crore) to Rs. 22,659 crore (from Rs. 20,199 crore as on 31.03.2001) and global deposits grew by 13.81 percent (Rs. 2346 crore) to Rs. 24,039 crore.

Domestic core deposits of the bank increased by Rs. 2817 crore during the year ended 31.03.2002 (accounting for an increase of 15.64 percent). Advances



extended to priority sector amounted to Rs. 3424 crore as at the end of March 2002 and accounted for 46.09 percent of the Net Credit (for priority sector purpose) as against the stipulated norm of 40 percent, to be reached by banks. Advances to agriculture amounted to Rs. 1338 crore as on March 31, 2002 constituting 18.01 percent of the total 'Net Credit' (for priority sector purpose) as against the stipulated norm of 18 percent, to be reached by banks. Thus overall the bank has shown improvement in all fronts.

Behind the screen

The CMD of Indian Bank, Ranjana Kumar had made substantial efforts to bring the bank out of its blues. For a bank, which made continuous losses from 1993 to 1999, the going always gets tougher. The present management and the staff of the bank have been making continuous efforts for the renewal of the bank. The Government of India has under an agreement with the bank, contributed Rs. 1300 crore as recapitalization assistance earlier this year (March 2002), which helped the bank reach CAR (Capital Adequacy Ratio) up to two percent levels. The condition put forth by the Government was that the bank has to meet all the quarterly targets

stated in the restructuring plan, which the bank is implementing since the start of 2000. At present the stipulated level of CAR is nine percent. The bank is expecting another round of funding of Rs. 770 crore, with which its CAR can hopefully meet the stipulated levels.

The bank management, as part of the restructuring plan has rationalized its branch structure, which helped it to reduce substantial costs. Branches that are not doing well were merged. As ineffective decision-making by lending officers badly affected the bank in the past, the bank suspended lending for a period of three years. The bank later on amended it and made a policy decision that accounts with credit limit of Rs. 50 lakh and above has to be managed by officers with specialized knowledge of credit.

To earn safe income, which is a must for financial intermediaries like banks, the management of the bank has started focusing on retail lending and housing loans and reaped rich dividends. The bank extensively undertook a brand promotion program and came out with special offers. A special festival offer announced in October 2001, has enabled the bank to disburse housing loans to the tune of Rs. 400 crore in just a four-month period. These schemes helped the bank to expand its loan portfolio without putting additional pressure on its non-performing debts.

The role of employees, presently 22,400, in the successful restructuring of the bank is worth praising. Recognizing the need of customer service in banking business, Indian Bank emphasized more on customer relationship management.

In a situation where there were possibilities of Government imposing restrictions on the wage structure and a moratorium in place on the payments of any arrears due to employees, the acceptance of employees to these plans and their adherence to the actions taken by the bank is admirable. In addition to a huge number of workforce, the sagging morale of the same was hindering the restructuring program at the bank. The bank has, under a scheme VRS 2000, relieved 3295 employees (1939 officers and 1356 award staff). Of this, 2919 employees were relieved during 2000-01.

The remaining 376 employees have been relieved during 2001-02. The post-VRS situation has been effectively managed without affecting the bank's performance.

The bank has taken two specific measures for credit expansion. First, the bank named 66 branches as 'credit intensive branches', which specialize in credit appraisal and sanctioning. Secondly, the bank is building a network of 'credit franchisers', particularly in the rural areas. The bank would lend to the franchisers, who in turn would lend to individual borrowers. The bank is awaiting RBI permission to launch the aforesaid scheme. In general, every bank has strong strengths where resources and energies are concentrated. Some are strong in treasury operations and some in servicing the corporate sector. In case of the Indian Bank, retail sector has turned out to be its strength.

The road ahead

Banks have come a long way from acting as intermediaries, who pool money from one group and lends the same to another, to being a one-stop financial shop providing all kinds of finance related services to their customers. 'Universal Banking' is gaining momentum in India, although it has been in practice in other parts of the world. This is changing the way banking business is conducted in India.

Noting these changes, Indian Bank has partnered with HDFC Standard Life to distribute the latter's insurance policies. This provides a scope for improving the non-interest income of the bank. The bank plans to focus on human resources in an effort to save costs and is in the process of delegating more powers to branch managers and adopting a more transparent structure.

For the current year, the bank has plans to be more aggressive in marketing the retail loans with special emphasis on housing loans. The bank is also working on a tie-up with the Union Bank of California for handling remittances from United States to India. The success of this tie-up will help Indian Bank in earning more fee-based income. The bank's overseas branches—the Singapore branch and the foreign currency banking unit, Colombo are active participants in

international syndications for financing Indian public sector undertakings, financial institutions and leading Indian corporates thereby enabling the bank to have a reliable source of revenue. The total business done by these two branches stand at Rs. 2814 crore for 2001-02. On the technology front, the bank as of now has computerized 501 branches and the business hours in these branches have been extended. A total of 72 ATMs were installed all through the country.

Though the future of the bank is looking optimistic, one cannot jump to the conclusion that the bank can sustain the profit levels and even grow further. Nevertheless, the bank has put up a decent performance in a situation where there is a slowdown in the economy and the banking industry itself is suffering due to recovery problems in the industrial sector.

Considering the present state of the economy and the capital markets, one should not expect the bank to support itself by internal fund generation or by approaching the capital market for raising capital, based on its own financials and net worth. However, any bailout package by the Government should be the last resort as otherwise it would defeat the very purpose for implementing the prudential norms for capital adequacy. This is a catch 22 situation for the bank.

The having off of the bank's mutual fund business to Tata Mutual shows that the bank does not have expertise in managing this business where there is ample scope for growth. The company is relying more on retail lending where there are big time players like ICICI and HDFC dominating the picture. It has to be seen whether the company can survive the competition from these players. Surviving is only a part of the big game. Ultimately what matters is whether the company can continue to sustain its profitability in the future. Can Indian Bank sustain its present performance? ■

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- 1 Turnaround in Banking Performance: Back in the Black, *Analyst*, August 1998
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Shashidar Mishra, Team Analyst

Reference # 1-2002-07-13

CORPORATE

MUL Disinvestment

Driving ahead

The change in guard at Maruti Udyog Limited (MUL) marks the start of a new race for India's largest carmaker. Rivals are fast encroaching its territory; auto demand is slumping and the race seems to be getting tougher and bumpier. In such a state of affairs, the moot question is — can Suzuki do to Maruti what the French auto giant Renault did to Romanian carmaker, Dacia?

It was a turning point in the history of Maruti Udyog Limited (MUL), when on May 30, this year, Suzuki Motor Corporation (SMC) officially took charge of it for a control premium of Rs. 1000 crore. Kicking off the second stage, the Government of India plans to renounce its stake fully in the country's largest carmaker by 2004. The disinvestment would give SMC a majority stake along with a dominant presence on the board. Since SMC will be enjoying operational freedom with Government limiting its presence on MUL's board to two part-time directors post-rights issue, Maruti would most certainly be run the Suzuki way.

The dominant position on the board would allow the Japanese company to take sensitive decisions such as the pricing, the level of indigenization, introduction of new models, import of kits, royalty and technology fee payments. SMC's complete control may mean new models and maybe even the final transfer of the controversial gearbox technology, which had, in the past, been a bone of contention between the two partners. It may also give the former monopoly, the much-needed fillip to fight competition from the likes of Hyundai and the homebred TELCO.

Suzuki driving

While the rights issue amount of Rs. 400 crore wouldn't suffice for crucial development investment, Suzuki's complete control over MUL would, nevertheless, allow the Japanese company to come out of Government's shield and face the cut-throat industry dynamics and changes in demand-supply patterns. The Government is also willing to step down from interfering with the appointment and management of the company's wide vendor and dealer networks. Also, as a result of operational freedom, such boardroom battles as the transfer of gearbox technology and the

face-off with the Government on the appointment of MD (reminiscent of earlier MD, RSSLN Bhaskarudu's case in 1999), which may impede their competitiveness, can be avoided.

Contrary to critics' apprehensions, Suzuki is not interested in rechristening the firm by adding its name and Jagdish Khattar will continue as MD. In effect, there would be little change in the company because it has already been a business unit making Suzuki's models. While everybody thought that Suzuki might utilize Maruti to promote its two-wheeler business, more so because their JV with TVS had fallen apart, Suzuki has sternly asserted that it has no plans to make Maruti participate in the two-wheeler business. In fact, it wants to keep Maruti independent and expand its export base and strengthen its position in India. Suzuki would be investing Rs. 250 crore in Maruti for setting up a die-cast foundry shop to further increase indigenization of its new vehicles and serve the balance local content demand in older models. Already some models, like 800 and Omni are 95 percent indigenized. The investment is the first after Suzuki took the majority stake in Maruti and it appears to be a good beginning. Suzuki also plans to introduce a new model every year.

Professor S Manikutty of IIM, Ahmedabad, says that though Suzuki is not a great company worldwide, it is still a good and respectable company. He opines, "Maruti is one of its showcases. It will definitely not like to see Maruti going down under. Global sourcing will help Maruti because it will enable it to build up scale benefits, it will deal with larger scale production skills; and it will also help its supply sources. Lastly, it will really hope to become a world player in terms of components and some car models."

Changing fortunes

Maruti, India's largest automobile company, entered the Indian car market



in 1983 with affordable cars for the average Indian. It collaborated with SMC, highly regarded for its enviable capabilities in small car manufacturing, to give the Indian consumer a cheaper and stylish alternative. Since then, it has launched a slew of new models in various segments of the market. MUL has been a leading manufacturer of a wide range of passenger cars and utility vehicles having an installed capacity of 250,000 units per annum.

However, over the years, Maruti has lost tremendous ground to its competitors, especially Hyundai Motor. It was suffering from losses for quite some time and 2000-01 was particularly bad for the company. But in a classic turnaround, MUL pulled itself from the slump in 2001-02, registering a net profit of Rs. 55 crore as against a net loss of Rs. 69 crore in the previous year. Last year, it pruned about 19 percent of its 5,646-strong workforce through VRS. At the same time, the company has completed a Rs 400 crore expansion project that has augmented the total production capacity to over 4,00,000 vehicles per annum to meet the growing competition. Though the company was successful in gaining some momentum, it remains to be seen

whether it will be able to sustain itself. Maybe, Suzuki's control will aid it in enduring the nuances of the demand-starved car market.

Maruti has always been important for Suzuki and so has Suzuki been to Maruti. This interdependence may take a different course in the future. As Manikutty notes, "For the time being the Suzuki acquisition of Maruti seems to be a good thing. Beyond five to six years one does not know whether the existing synergies will continue. Global market knowledge, new product technology, export possibilities, and a way of working are things that Suzuki can bring to Maruti. 100 percent ownership can reinforce this."

Maruti has been playing an important role as Suzuki's export base for Europe and South Asia. Suzuki's control would enhance Maruti's competitiveness for not just the Indian market but also globally. Suzuki would also encourage "a component exchange program" for Asian countries where the Japanese carmaker has a presence. These include markets like Indonesia, Malaysia, Vietnam and Myanmar. Further, Suzuki would promote Maruti as a global hub for sourcing some of its cars besides launching a new model every year.

Back seat driving?

True that Suzuki can help Maruti in firming up its act in the country, but the Japanese auto giant may have little more than its technological and engineering capabilities to offer. What it can give Maruti, though, is its management practices and wisdom on cost-cutting and efficiency. It can also help in marketing. Suzuki can further Maruti's already sound strategy of a services thrust. Like most global auto companies faced with slumping sales and dwindling demand, Maruti too is pushing for services. Interestingly, GM, which has a stake in Suzuki, has done just that over the years. Maruti Udyog recently launched its pre-owned car business in Faridabad, Haryana as part of the company's four-pronged entry into the services related areas, which include lease and fleet management, auto insurance and auto finance. Faridabad is the ninth city where the program named "Maruti True Value" was introduced. Maruti is banking on this program to expand the family of Maruti customers, provide mobility-related solutions and extend its relationship with the customer during the entire ownership cycle. Maruti's servicing network can prove to be a major advantage to this

The Deal at a Glance

Suzuki currently owns 50 percent stake in the firm, government controls 49.6 percent and the employees the rest. The rights issue amounting to Rs. 400 crore for a total of 12.19 lakh shares at a price of Rs. 3280 per share, would see the government relinquish its portion of 6.06 lakh shares to Suzuki Motors for a premium of Rs. 1,000 crore. Post rights, the Suzuki holding in MUL would rise to 54.2 percent while that of government would drop to 45.54 percent. The balance would be with the employees in proportion to their present stake.

Continuing with the disinvestments process, the government would offload its remaining equity through public offer in two phases by April 2004. In the first phase of public offer, government would lower its equity to 25 percent by March 2003 and the rest would be divested in the following year. Suzuki has agreed to underwrite the first public issue of about 36 lakh shares held by the government at a price of Rs. 2,300 per share. The government and Suzuki would shortly sign a new joint venture agreement that would supersede all previous agreements. Under the proposed agreement, Suzuki will make MUL the global source for certain models, assist MUL access new export markets, give MUL discounts on certain components, set up a task force to explore further cost reduction possibilities and aggressively strengthen MUL's manufacturing and technical capabilities. According to the agreement with the government, Suzuki will also continue with the component discounts it forwarded MUL as part of the company's cost-cutting efforts, last fiscal.

venture. If it is successful in services it would have a significant upper hand vis-à-vis its rivals, most of whom don't have such an elaborate network. Professor Chandrasekhar of IIM, Bangalore says, "Services are crucial and there is need to focus on this. The market is very competitive. Financing car purchase and second-hand car sales is also a lucrative market where a presence is important to acquire and retain customers. This is what is going to differentiate companies. Maruti's very large domestic base and distribution network makes it imperative that it does not lose out on these aspects."

The race ahead

The time is portent for Maruti — arch rival Hyundai Motor India has announced its intention to go public; Fiat India and General Motors are evaluating synergies; others like Ford, Telco are flexing their muscles. The first signs of the marathon can be clearly seen. And, if Maruti has to stay in the race, the Government has to give up any temptation to interfere in the affairs of the company. Hoping that Suzuki would have complete control, unlike in the case of Tata-VSNL where the Government is very vocal against VSNL investing in Tata Teleservices, Maruti can dream of winning the race. Manikutty reflects, "I would say that this privatization will work if the Government keeps its paws off."

Can Suzuki do a Renault?

A year and a half after its privatization, Romanian carmaker Dacia is recovering. Its production and sales have grown in the first two months of this year and the company is also planning to expand into other markets. Dacia started producing cheap cars for the local market with the help of French Renault, one of the world's top 10 automobile producers under a 12-year license agreement. After the License agreement expired in 1978, it continued production on its own. For more than 20 years, Dacia was one of the communist regime's major exports to other Eastern-bloc countries. But with the collapse of communism and with it the regulated Eastern-bloc market, Dacia was faced with tough competition. It quickly lost its foreign markets and began experiencing difficulties at home. Its troubles never got better until in 1999, when Renault chipped in. Renault bought an initial 51 percent of Dacia for \$50 mn and a pledge to invest some \$220 mn over the next five years. At present, after two subsequent stock acquisitions, Renault owns about 80 percent of Dacia. The French auto giant used Dacia's skilled workforce and low wages for its success in emerging markets. Essentially, Suzuki may not be as popular and strong as Renault and Maruti may not be as desperate as Dacia, but Suzuki's control would be for the good, if not better. ■

C S V Ratna, Team Analyst

CORPORATE

Arvind Mills Ltd.

Restructuring paying off

It might be Arvind Mills' fight for survival in the denim business, but its entire debt-restructuring plan is a precedent in the Indian corporate sector.

Sanjay Lalbhai should now be the most happiest CEO on earth, given the successful way in which he has handled the deep debt (a massive Rs. 2,700 crore) troubles that Arvind Mills was forced into because of its over exposures in its flagship denim business. The troubles were so deep that the company was losing nearly one crore rupees per day. It was not able to pay the interests to the lenders on the debts taken and the company was almost on the verge of a collapse. It was at this time that Sanjay drafted a proposal for restructuring its entire debt. In a way, this proposal was a unique one, because this was never tried before in India and thus made the task of convincing the lenders to agree to this plan more complex.

As a result of the restructuring plan the interest burden came down substantially and got Arvind Mills the distinction of becoming the first Indian corporate to restructure its entire debt in a single go. Also, post restructuring, Arvind has reported a profit of Rs. 10 crore for the first quarter of the financial year 2002, after a gap of three years. The sheer instinct of Sanjay to survive in the business coupled with some bold and frank decisions had enabled Arvind Mills to come out of its problems and stand again on its feet.

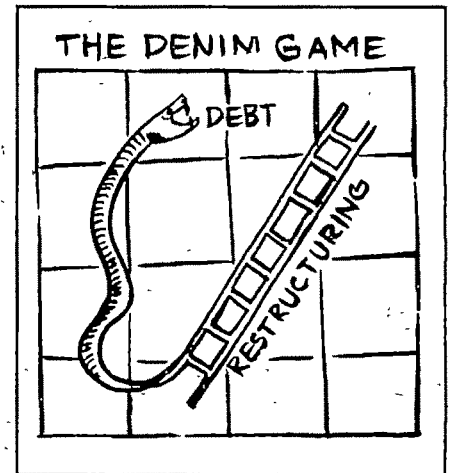
The long journey

The Arvind Mills Limited is the flagship company of Rs. 20 bn Lalbhai Group. The group was founded by three Lalbhai brothers: Kasturbhai, Narottambhai and Chimanbhai in 1908 and has been operating on full-scale vertical integration since 1931. In the mid-1930s Arvind Mills diversified its portfolio by switching to high quality fabrics and until 1986, the portfolio consisted of conventional products like sarees, snitings and low value shirting, and dress materials. There was no niche area for Arvind Mills to operate till then. In 1986, Arvind identified

denim as a niche segment and had set up India's first denim manufacturing plant in Ahmedabad. It has pioneered the use of denim into non-traditional areas like Indian outfits, corporate gift articles, stationary, and even briefcases. Over the decades, Arvind Mills had become one of the country's most respected business houses and by 1997, Arvind Mills Limited had become the third largest producer of denim in the world. It is also one of the largest complex cotton textile mills in the world and is one of India's most diversified business houses, with a significant presence in the textiles, ready-to-wear, agrochemicals, air-conditioners, and telecom industries in India. Inspired by its success, Arvind established its fully owned subsidiary, the Arvind Overseas (Mauritius) Ltd., which is one of the largest cotton textile conglomerates in the Asia-Pacific region. The dreamrun of Arvind Mills continued till 1998. It was only when the world of fashion started replacing traditional denim with gabardine and corduroy coupled with the sudden collapse of global denim prices, and increase in naphtha prices, that Arvind Mills had started feeling the pinch.

The denim passion

The number of operators in the powerloom sector had increased substantially by 1987 and Arvind Mills, which was the major player till then, had to forego some of its marketshare to the new entrants. As a result its profits declined and Arvind Mills had reported its lowest ever profits (Rs. 76 lakhs) in 1987, since its inception. This made Sanjay and his team to look at more profitable opportunities to invest. The idea was to invest in higher end garments, which require superior technologies to manufacture, where the medium scale powerloom operators could not hope to match. It was then that Sanjay and his team had their eyes on denim, which had a good future worldwide and appeared as



a good bet for them. This was the beginning of Arvind's denim saga. Keeping pace with global trends, Arvind Mills also invested aggressively in the denim garments business between 1991 and 2000. Between 1991 and 1996, Arvind Mills had raised Rs. 1,054 crore to finance its expansion in the denim. This also included the Rs. 392-crore euro issue. The denim business by 1996 had constituted 65 percent of Arvind's portfolio.

The prices of denim were at their peak during 1996-97 and a meter of denim costed Rs. 93. This tempted Arvind to invest further in the denim and Arvind exposed itself to high levels of concentration risk in denim. Believing that scale of operations along with low cost of production would give them an edge in the worldwide denim business, the company had put-up a massive manufacturing factory at Santej, Ahmedabad, in 1997. Arvind took \$75 mn External Commercial Borrowings (ECBs) from the Bank of Nova Scotia-led consortium for this purpose. This new project was supposed to bring in huge cash flows for the denim business. But, unfortunately for Arvind, the global denim business started collapsing from 1998 and the prices of a meter of denim

fell down to as low as Rs. 70 from Rs. 90. This huge drop in the prices of denim costed Arvind crores of its investment, as Rs. 1 per meter drop in denim would result in Rs. 10 crore cut in the company's bottom line. There were many reasons attributed to the sudden downfall in the global denim prices, some of which, like fashion, demand and supply imbalances, were external to Arvind to monitor and control them. Since denim was at its peak for almost 20 years, huge quantities of denim were available all over the world and so supply exceeded the demand, which had further depressed the global prices of denim.

This was when Arvind committed the biggest ever mistake. The management thought that this downfall in the prices is a temporary phenomenon and they still infused further funds into the denim business. But they were proved wrong. Added to this, was the increase in the prices of the naphtha, which is used as feedstock in Arvind's captive power plants. This had further eroded the bottom line and the long-term debt taken to finance all the expansion projects related to denim had reached a whopping Rs. 2,700 crore, from 85 institutional lenders all over the world. While there were virtually no returns on these investments, the interest burden started getting bigger and bigger every year and worse still, Arvind could not generate adequate operational cash from its projects to service its debt. Of the total long-term debt, the foreign debt was Rs. 929 crore; Rs. 580 crore in the form of floating rate notes, which are unsecured and Rs. 349 crore which is a fully secure syndicated loan. Indian institutional investors constituted Rs. 1771 crore of the debt. Of all the Indian institutional investors, ICICI is the largest lender with over Rs. 500 crore. While the overemphasis on investing in denim, even when the global denim prices were falling down, had questioned the credibility of investing further in denim, it

also posed serious doubts on Arvind's sincerity to safeguard the interests of the lenders.

Restructuring blues

In order to survive, Sanjay knew that Arvind Mills had to reduce the huge outflow of cash in the form of interests on its debts. Jardine Fleming was thus appointed as advisor to restructure the entire debt. Prior to this ICICI along with a consortium of offshore lenders, had appointed consultancy firm, KSA Technopark to prepare a feasible report to restructure the entire debt. Arvind along with Jardine had prepared a five point template for restructuring: One is ensuring parity among lenders; two, keep the process transparent by keeping bilateral deals out; three, make the process interactive by forming a lender's steering committee representing 60 percent of total debt, which would then be a forum for negotiating restructuring terms; four, keep servicing working capital interest and also repay retail debt to small investors; five, make the restructuring a priority by dedicating cash flows to debt servicing for the next 10 years.

The crux of the restructuring plan was that Arvind would be able to clear only 60 percent of its total debt and all the working capital borrowings and the debts of the retailer investors would be kept out of the restructuring plan to reduce the total amount of debt that is to be restructured. KSA Technopark had made a 10-year period plan with projection of Rs. 1200 crore net present value of operating cash flows and Rs. 800 crore (40 percent) would be written off. The plan was offered to the investors in three options effective from April 2000. Investors who wish to exit the company immediately would take the biggest write off (55 percent). Also, they would not be paid any interest. The investors who wish to exit the company after five years would be paid their full principal with

four percent interest and those who wish to be with the company for the entire ten-year period, would be paid full principal and 10 percent interest. The main aim of the restructuring plan was to decrease the interest and finance costs.

Financial Performance (Rs. mn)

	March 2002	March 2001
Net Sales	6996	6169
PBT	193	-1823
PAT	193	-1823
EPS	1.39	-
% OPM	22.2	10.5
% NPM	2.7	-29.9

Source: www.equitymaster.com

The restructuring proposal was not music to all the lenders. But because of (a) surging global denim prices and (b) Arvind Mills becoming operationally more efficient and effective, the lenders, mainly the institutional lenders, did not try to oppose the proposal. One or two, who had rejected the proposal, finally had to give their assent, as the Gujarat High Court gave legal approval to the plan.

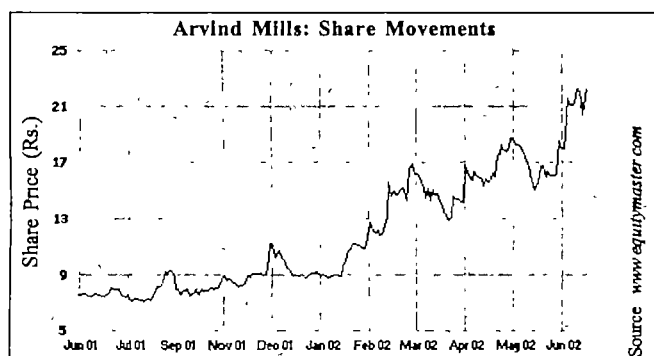
A lesson well learned

The restructuring enabled Arvind to reduce its interest costs by 60 percent, which is nearly Rs. 150 crore per annum. Arvind also took several strategic initiatives to improve its operational and functional efficiencies. The company had shifted from its policy of producing commodity denim fabrics to producing value added denim styles. Arvind plans to sell all its non-core assets in order to clear the debts of those investors who wish to leave the company immediately. It also announced rights issue of equity shares, went for fresh borrowings and internal accruals to meet its debt buyback obligations. The company was able to reduce the consumption of raw materials and finished goods purchases, thereby saving cash outflows. All these steps helped to again report a profit of Rs. 10 crore in the first quarter of 2002-2003 after a gap of three years.

The whole episode was worth a lesson for corporate India, especially to those who pile up the inventory levels and go for rapid business expansion without properly assessing the external and internal business environments. Arvind Mills too had learned a lesson from its mismanaged expansion plans. Now, the company was focusing more on making value added denim in the global denim market and has redefined its core competency, which is now 'product innovation'. ■

Ramakrishna Neti, Team Analyst

Reference # 1-2002-07-15



CORPORATE

GlaxoSmithKline Pharma

Striking back

Faced with stiff competition from domestic companies and declining demand, GlaxoSmithKline India has opted for a massive restructuring. Not only are the results of the restructuring good but they are also encouraging the pharma giant to look into the future with optimism.

Last year, Glaxo India joined the long list of companies that are trying to restructure their business. Though it is one of India's largest pharmaceuticals company by marketshare, it has been forced to restructure its business in line with the global parent to enhance its future profitability. After a year-and-half of restructuring, it has come back more strongly and reported good sales and increased profitability. The worst seems to be over for the pharma giant. After its successful merger with the SmithKline Pharma division, GlaxoSmithKline (GSK) India is showing impressive figures and the organization is confident of making big in future.

Big move

Following the restructuring exercise undertaken in GSK India, it now seems that it is coming back into reckoning strongly. The restructuring exercise being taken up by the pharma major in line with its global parent has enabled to improve its figures in the financial year 2001-02. Merged with SmithKline Pharma division, the company has come out with an impressive growth. After struggling for nearly two years and in the face of declining marketshare and poor demand, the company has been forced to undertake massive restructuring. It has opted for restructuring at a time when its operating margins started to dip, sales showed signs of stagnation. At the same time, it was saddled with excess manufacturing facilities, labor force and low margin products. All these factors had made the company to lose its marketshare. The company has a little over six percent marketshare in India and it is very much

crucial for it to sustain this. A six percent marketshare in India is a commendable marketshare considering the fact that Indian pharma market is overcrowded, highly competitive and fragmented.

The restructuring drive mainly focused on trimming costs and enhancing competitiveness. Its mission statement was crystal clear from day one—"Grow profits faster than sales and retain market leadership." With a target of doubling its margins in three years the company has adopted every possible strategy. It included selling some of its manufacturing facilities and resorting to third-party manufacturing to rein in expenditure. It has closed down Glaxo's Worli facility in Mumbai, which would result in a saving of around Rs. 22 crore in staff costs alone. Apart from that, the company is also selling most of its expensive real estate in Mumbai and Bangalore. This exercise is believed to release cash to the extent of Rs. 150 crore in the current fiscal. It has also shed a little over 10 percent of its workforce by introducing a voluntary retirement scheme. The company at that time announced that the positive effects of these measures would get reflected in the FY02.

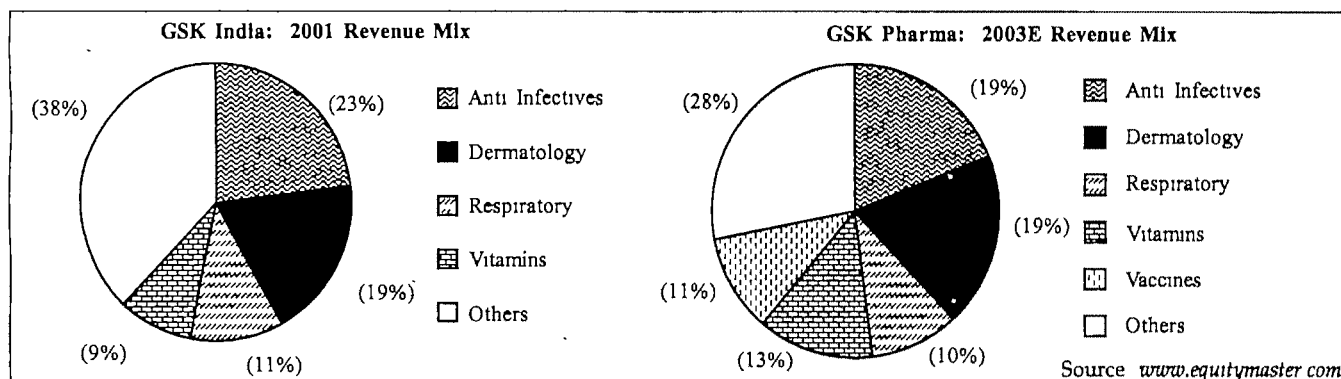
To achieve its target the company has embarked on a three-pronged strategy. Focusing only on key brands and therapeutic segments, channeling the existing cost structure by resorting to every possible cost rationalization strategy and leveraging on the marketing strength developed over the years. All the strategies adopted and those yet to be implemented are based on this three-pronged strategy. Already the results are encouraging with the organization



becoming more lean, thin and rejuvenated. On the financial front also the strategy has enabled the company to post good results for the FY01 and in the first quarter of the CY02; its sales have gone up and operating expenses came down. Experts feel that this is a positive sign for the company and are hopeful that it will meet its expectations by the end of CY02. An industry expert claims, "With sales growing at a healthy rate of 9.5 percent year on year for Q1 CY02 and operating margins improving by 490 basis points, we remain confident that the company will achieve the CY02 targets."

The optimism about GSK among the investor community is understandable by the fact that it has shown good results. Its operating margins improved to 14.1 percent. Staff costs have come down by 12.5 percent. The steep reduction in staff costs is due to the VRS offered. Also the sales rationalization based on the company's new focus on 30 strategic products identified by it has enabled to improve the margins. Following the new lines of focus, the company has decided to concentrate only on branded products and has announced the closure of its rural marketing division thus moving out of low-end generics.

The optimism about GSK among the investor community is understandable by the fact that it has shown good results



In a move to consolidate its position the company has also deferred launching new products. The company plans to focus more on profitable and strategic brands. According to an insider, the contribution of these products is likely to go up by 47 percent of total sales in the next couple of years. It is already pruning the 240 plus product portfolio by putting aside some of its tail brands and ceasing to promote some of its older low-margin products. In the process, the company has hived off five products in FY 01 for Rs. 24 crore. Similar plans of divesting, discontinuing or contracting out are in the pipeline. Not only are the product lines being streamlined, the company is also streamlining its distribution network. On the other hand, it has shifted the emphasis to more complex and highly profitable biotech products. It has introduced a new oral treatment for Hepatitis-B (a combined vaccine for Hepatitis A & B), oral smoking-cessation product called Zyban and has also entered into a joint marketing tie-up with Ranbaxy Laboratories. According to an industry expert, these new products are unlikely to find any competitors in near future and hence can boost the company's profitability. Though competition from highly

commoditized "generic generics" remains, the company is hopeful of sustaining its leadership through more focused effort with existing products. It seems that the company is trying to penetrate more into the market with existing brands and products rather than with new products and testing the waters.

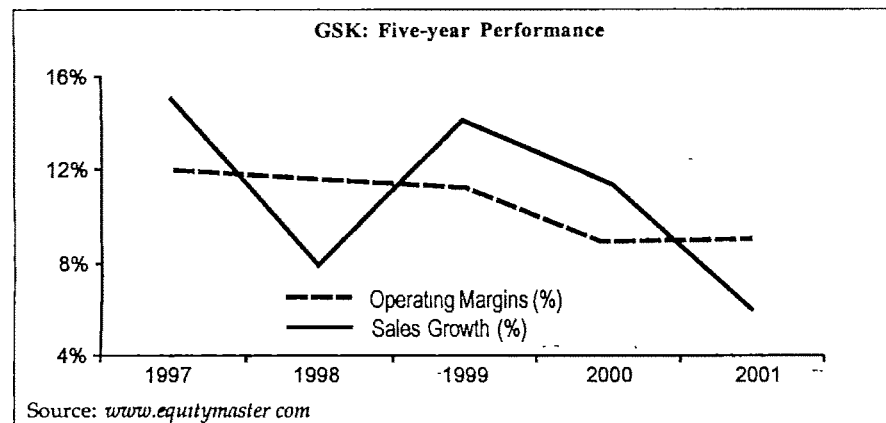
Future perfect

Glaxo India Chairman, Deepak S Parekh in his last year AGM painted a brave picture. Following the success of the restructuring that Glaxo has gone through after its merger with SmithKline Beecham Pharma division, the optimism surrounding the chairman can be easily understandable. He said, "Perhaps ten years from now we might be carrying cards just like credit cards which would tell a doctor about our entire genetic make-up. Genome mapping will help GSK in discovering novel targets and effective treatment. It will also help in having a blueprint on which they can develop new drugs." No doubt, post merger, Glaxo is enjoying enhanced marketshare, better reach and cost synergies. But painting such a long-term picture is definitely a brave act. Perhaps

the chairman is confident about the achievement of the company's targets.

Referring to the long-term success of GSK, an analyst said, "Though the companies' product portfolio boosts of some very strong brand names, the portfolio faces stiff competition from domestic companies. At the best the company can grow in line with the industry growth rates of 7-8 percent." The growth rate of the industry nor the company is attractive enough to bring the investor's. However, the restructuring benefits of the company are translating into improving valuations in the stock markets. But sustaining the growth rates without new products may not be possible. So doubts about the long-run growth remain intact.

In spite of the concerns, GSK India is going to benefit more in future. Especially in the wake of dilution of DPCO (Drug Price Control Order), many of its strong brand names are going to move out of price control. At present, 50 percent of the company's sales come from DPCO controlled products. So the dilution of DPCO control will enable major brands like Zinetac, Cobadex, Septran and Zevit to come out of price control. These brands represent 15 percent of the total turnover of the company. Also, once Exclusive Marketing Rights and Intellectual Property Rights coming into force in 2003-04, and higher awareness in health and welfare spending is bound to help the company in improving its margins. Though the stock may not look attractive till 2003-04, both the company management and analysts are optimistic about the future of the company. ■



Y Chandra Sekhar, Team Analyst

Reference # 1-2002-07-16

BOOK SUMMARY

Growing Global

A Corporate Vision Masterclass

The book describes insights and strategies practiced by Acer group Chairman and CEO Stan Shih. He offers readers a collection of teachings, personal reflections and philosophies on global-business management in the dynamic and highly competitive IT industry.

Growing Global exposes an insider's view of the keys to the development of the Acer brand. Shih openly shares the successes and failures of Acer in the hope of reducing the learning curve for other Asian firms. It is also directed toward non-Asian executives who want to gain an in-depth understanding of the business context and challenges particular to their Asian counterparts. By better appreciating how Asian businesses operate, Shih hopes that non-Asian executives can develop fruitful alliances with their fellow business-makers in Asia, as we all learn to navigate for success in today's globally integrated knowledge-based economy.

Shih uses *Growing Global* to share his views on knowledge management, development strategy, and organizational design

in the information era and in light of the IT industry trend toward super-disintegration. Specifically, Shih presents his concept of the Internet Organization (IO), an innovative approach for effectively utilizing and managing global resources in the 21st century.

Paradigm shift

Prior to the '90s, many countries regarded protectionism as beneficial to themselves, believing that their economies could be self-sufficient.

Taiwan, at one time the local market for home appliances was protected, making it very difficult for imported products to establish themselves, with the eventual result that the Taiwanese home appliance industry never developed international competitiveness. As far as IT products in Taiwan, duties on imported finished goods are currently 5 percent while the tax on imported components is 20 percent. With the help of this anti-protectionist policy, Taiwan's IT industry has developed international competitiveness. The facts show that prolonged protectionism has no successful precedents, though for industries in the beginning stages of development, there is nothing wrong with the early support and guidance provided by protectionist policies. The situation can be linked to rearing offspring; nurturing provided during childhood is desirable, but permanent coddling and

protectiveness prevents development into mature and robust adulthood.

A borderless market economy: Why is the market increasingly borderless? Because a growing proportion of items that everyone wants is not physical goods, which makes them easy to share. All that's needed is to create value, and even if the benefited party pays an extremely small fee, thanks to the large volume of sharing, it can add up to an enormous success. The vigorous development of the US economy during the '90s occurred due to technology sharing, especially in the area of software.

In the borderless market, for a concept to become globalized, local environments must be studied and understood. In the same manner, if a product is not the result of combining the best that the world has to offer, it is not competitive, and its success cannot be sustained.

Recently, the notion of 'decentralized organizations' has been much discussed. In fact, the term decentralized in this context is somewhat misleading as there must always be a 'center' for any task, to initiate and lead. However, in a decentralized organization the center is not fixed, but is determined according to the particular task at hand. The same principle applies to entire industries even if a company is small it can be the center at certain junctures, and the role of a large company may be that of a satellite supporting the center.

The Internet era is one in which businesses will follow the super-disintegration model. Companies are now more into strategic outsourcing. In the early '90s, the US began adopting this concept, which meant concentration on core abilities and handing over other tasks to outside companies. The advantage of outsourcing is that a company can stay focused, and even if costs are lowered, the outside company providing the outsourced services is certain to be more of an expert in those areas and any lowered costs would just be an added bonus.

Super-disintegration works this way in the information technology industry. Dell and IBM were not proficient at manufacturing, so they outsourced it; insisting on doing it in-house would only have made it a burden. This outlines the idea of outsourcing, which was quite novel at that time, even if it seems like an inevitable development now.

Industry Paradigm Shift	
Computer architecture evolution	Industrial evolution
Mainframe	Vertical Integration
↓	↓
Client-server	Disintegration
↓	↓
Internet protocol	Super-disintegration

STAN SHIH

GROWING
GLOBAL

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The development of computers can be schematized as shown in the above figure. Network protocols are very simple things in themselves, but with the global open standards and self-governing system they make possible, the way the whole world works can be said to depend on them. Managing people and computer development have similarities, which can be seen from the parallel between the history of computer designs and the evolution of organizational structures. Computer architectures are continually being adjusted to meet changing requirements moving from mainframe computers all the way to the Internet. The management of people and organizational structures will move in similar directions in the future, going from the ideal of vertical integration, wherein one does everything on one's own, to disintegration, and then on to super-disintegration. The difference is that organizations must focus on people, who can't be captured by the simple model of a computer.

The digital revolution is creating the new economy and in various places around the world, it is possible to see the impact of changes brought about by the new economy. Even though people in these places can keep up with the latest trends, they unfortunately have no role spectators, and the author hopes that North-east Asia can avoid such a fate and play a role in the present scene. In the new economic order of the Internet era, we must be actively engaged in obtaining a role; perhaps it won't be the starting role, but at least it should be a key supporting part.

In the new economy, things are happening everywhere, and everyday we are in the situation of having to react without preparing as fully as we would if there were more time. What is the right approach to take? The critical factor is not so much the amount of raw effort put into the preparation, but how well we can utilize resources, move in the correct direction, and lead our organization to do the right things. Even more importantly, you must establish an appropriate organizational structure and culture, as this will make it easier to adapt to and even take advantage of the change.

Using small size to win big

In the Internet age, businesses will not compete on the basis of who has more people or covers the bigger territory, but on the value they create. The most important consideration in the era of Internet economy will be whether you can create variable bits - digital information, content or solutions. The most distinctive feature of the Internet is that avenues for doing business are everywhere. Knowledge in the Internet economy is disseminated as bits, and the influence it produces may reach almost everywhere, challenging old traditions and values. In the new economy, the way to wealth has been drastically altered. The mode for creating wealth advocated in the past, even if a few principles still apply, has been affected by the advent of the Internet in such a way that it may no longer be of much use.

In the Internet economy, how is value produced? Most people focus their attention on the fact that the value of B2B transactions is potentially very large while B2C transaction values will likely to be very small in comparison, with little profit to earn, leading to the conclusion that effort should be focused on B2B. However, in gauging value in the Internet economy, we should look at the fees collected from e-commerce transactions, and not the total value of the transactions.

The author claims that Taiwan's PC industry currently consists of less than one percent of the world market. China and

About the Author

Stan Shih is Chairman and CEO and co-founder of the Acer Group. He has built the company into one of the world's top ten global PC brands using his own unique management methods. His numerous industry accolades include International Business Executive of the Year (Academy of International Business); Business Hall of Fame (*Asiaweek*), and one of the Top 25 Managers of the Year (*BusinessWeek*).

indeed the world will succumb to an Acer management slogan: "Use small size to win big". That motto has helped the group weather dramatic changes in PC-related industries. The latest, the advent of rented applications as Shih puts it: "making the use of software akin to the use of electricity or water." That is, you are charged for how much you use. The secret for navigating such shoals is "large-scale re-engineering," he writes. "A company should undertake [it] every five years." Acer's first re-engineering worked well. In 1992, Shih applied to PC manufacturing the principles that McDonald's applied to fast food. Just as burgers were adapted to national tastes, Acer desktops were configured downstream to suit local users. In 1997 he began "re-re-engineering," which included introducing Acer to a US concept "total brand management."

In the past, doing business meant talking about how much market share you had, but in the Internet economy, the key thing to look at is the proportion of the total value that you create. Another misconception is that in the Internet economy a winner can beat out all other competitors and completely take over. Furthermore, the advantage of the Internet is that even if you get beaten, you can still make another go of it. Right now, everyone is trying to do portals, but this approach is open to question. Once again, the Internet is about super-disintegration; there is an unlimited number of market niches in which value can be created.

The Internet has another area with great potential; companies can use Internet business models and technologies to lower costs. Creating a new market is not easy, but companies can use the Internet to reduce their present costs of doing business. The value created in this way is not less than that from new business opportunities. You must not neglect the use of the Internet as a tool for enhancing your current operations. The Internet's potential as a business tool is as a medium where new business opportunities can be discovered. However, too many people see the Internet as a new business while neglecting its importance as a tool. Therefore, seeing the Internet as a tool is vital. Many companies in Hong Kong have done this, with even real estate companies becoming dot.coms; however, just changing a name is undoubtedly not enough.

Internet organizations

The iO can be viewed as an evolution of the network organization and client-server management structure concepts that Shih has presented in the past. The iO is based on "virtual dream teams", which he envisions as small, ever-mutating groups of specialists who "task" get together as a team, accomplish a project, and when finished, move on and reassemble for a new project. Shih claims that this "can turn Acer into a 'higher form' of organization."

He also introduces what he calls "Stan Shih's Competitiveness Formula" to explain how competitiveness can be amplified through the creation of value and the lowering of costs. In relation to this concept, Shih revisits his infamous "Smiling Curve," analyzing the curve from the perspective of the current

GROWING GLOBAL

IT industry. He stresses that the winners in the industry today and tomorrow are those companies that are most customer-centric, innovative, and committed to providing outstanding service and developing intellectual property such as software.

The emergence of super-disintegration means that the most standard and open protocol or specification becomes an extremely important foundation for business. The main objective of such standards is to allow companies to more easily meet various new market requirements as they develop. In the recent evolution of human societies, the industrial era has developed into the information era, which then metamorphosed into the era of the knowledge economy. Industrial development has also evolved from the predominance of vertical integration to disintegration and then to the super-disintegration of today.

The Organization Evolution		
Economy	Industry	Organization
Industry	Vertical	Integration/hierarchy
Information	Disintegration	Flat/empowerment
Knowledge	Super-disintegration	Network

As computing power and talent become ever more accessible, organizations evolve. Organizations can be classified as hierarchical or networked. For a hierarchical organization, the larger the organization, the easier it is for disjunction to occur, where the higher levels don't understand the lower levels. Making decisions may require a very long time, and the problem of high operational expenditures can easily arise. As a result, the organization evolves into a flattened structure with greater reliance on delegation at each level as a way of avoiding the problems that are inherent in a hierarchical organization. In actuality, the concept of a network organization was introduced some time ago, but there is as yet no definitive conclusion, and this is an area of further investigation.

Internet organizations meet the needs of a knowledge-based economy and super-disintegration business environment. The Internet organization is an extremely unique, effective model that can aid many businesses in raising their international competitiveness. Many people complain that Taiwanese companies' willingness to be niche leaders is a negative attribute, and many people have hoped that the government would follow the lead of the South Korean government and actively cultivate a large world-class enterprise. In an Internet organization, each company is like a website, being independent and responsible for itself, while focusing on the most optimal contribution it can make in its chosen field. Because each company is independent, but has the ability to work well together and conform to protocols, the organization as a whole can develop rapidly. In an Internet organization, shared benefits for all parts of the organization must be established in order to make effective management possible.

Inspiring creative thinking

Since innovation originates from creativity, stimulating creativity is obviously vital but how can this be accomplished? Contrarian thinking is the key because the way to get furthest from the current direction is to first make a 180-degree turn in the thinking style. If this is done today, radical action need not be taken tomorrow. Hence, use thinking; after all, it costs nothing. Contrarian technique works as follows: first, think in a direction

Snapshot

- There are many products and technologies that are globalized with a unified standard.
- In the new economy, it is difficult for a business to do everything on its own. A single company or business unit cannot do everything on its own, there is no way to compete that way.
- Internationalize marketing means understanding markets, and each region's market is different.
- Internationalization means having your own people assigned overseas all the functions involved in running a business.
- As a business pursues excellence, the most basic qualities it must possess are a great vision and culture.

180-degrees away from the current direction, and see if there is some answer for the issue at hand. After contrarian thinking, you must rely on collective brainstorming, and at this time you need someone with a great deal of experience to lead the discussion. However, before this communication takes place, the executive must first confirm whether an employee is just talking off the top of his or her head, or if what he or she says has substance. In running a business, persuading someone else is what you know, which has no value; learning something is more valuable.

The impact of social education on innovation is greater than that of academic education. The enormous North American market is an important engine behind constant technological innovation, but this should not be attributed to a greater capacity for innovation in a country like the US, which is much younger than other countries with a long history and tradition. We have the opportunity to innovate constantly and to develop these capabilities. The things we create have a chance to lead the world, with even Americans accepting them gladly.

Approaches to globalization

During the past decade, commonly heard words in economic circles have been globalization and liberalization. The slogans are proclaimed loudly, but there are few people discussing what globalization actually is. In fact, globalization has two levels of meaning. One of these is doing business abroad, which is globalization in a geographical sense. The other level is defined in terms of action in the sense that an international standard must be reached in whatever a company does.

Globalization requires certain methods, and companies can consider those used by successful western and Japanese multinationals. However, for Asia the most important thing is to develop an approach that is uniquely suited to its particular circumstances.

It is difficult for most Asian companies to internationalize. Their local markets are likely to be too small, making them unsuitable as a training ground for doing business globally, and it is very difficult to build up a global brand starting from the local market. In addition, there is a shortage of internationalized workers, and there are no similar markets that can be expanded into.

The Japanese and US experiences can serve as reference points for Asian companies, but should not be imitated. If an Asian company merely copies their approach, it can only aspire to being a second or third rank company at best. Asia must have its own unique approach, and this is the reason for Acer's spirit of aggressively undertaking to develop new approaches.

On the road to globalization, most of Asia faces relatively few problems in the areas of manufacturing and R&D, while its challenges in marketing are the greatest. For Asian companies to internationalize, a large number of internationalized talents are needed. However, Asian companies should not feel too discouraged by this; they are not the only ones facing this challenge. The businesses in every country have their own burdens, but there is no choice but to try and overcome them by constantly making adjustments and searching for new approaches.

From OEM to OBM

The biggest challenge for Asian businesses and companies in other smaller countries as they internationalize is brand management. If their local markets were large enough, such as mainland China or the US, creating a strong brand would be easier. To establish an international brand, the first priority is to gain a large market share in countries nearby. It's very easy for Asian companies to do Original Equipment Manufacturing (OEM). All that's needed is to establish appropriate capabilities and to work cheaper than somebody else, and the OEM customers will come to you. If you add in better design, you're ever more competitive. However, the problems with OEM become evident over the long-term. Maintaining strong performance over a long period is difficult.

In general, the major transitions to be made in moving from OEM to OBM (own-brand manufacturing) can be summarized as: from simple to complex management, from large scale to small, from short time frames to long, from few customers to many. OBM is much more complicated business than OEM, and management is correspondingly more difficult. Whereas the scale in OEM business is large, OBM means establishing a

customer base of one customer at a time, meaning that it is not easy to achieve a large scale. Shifting from OEM to OBM means shifting from short time frames to long; when a company is doing OEM, all that needs to happen is for the customer to place an order, and you can do the production and delivery; but with OBM there are many preliminaries, after-sales service, and other steps to take care of, so the time frame is lengthened. Customers also change from being few in number to many. Therefore, the challenges are formidable while making the transition from OEM to OBM.

Vision and corporate culture

A vision is not simply a goal, but something that is worth everyone's long-term effort. Becoming world number one is a goal, but not a vision, if you become number one, what then? A vision is something you pursue constantly over a long period of time, and not something you can achieve by tomorrow; however, it can't be something so distant it seems unattainable. Few will have the patience to pursue something whose end they cannot see, a vision they have no confidence in. The direction expressed in a vision must be correct. In establishing a business, there must be some idea behind it, a mission, and a vision should be related to the mission if it is to be effective.

A vision provides cumulative results; a business is built up over time, and to become effective it has to encourage everyone to work in the same direction. To make the results of these efforts grow, a vision is needed, and no task should stray from the imperatives of the vision. This is especially true of running a company in the current business environment, which, although free is extremely competitive. ■

N Janardhan Rao, Team Analyst

Reference # 1-2002-07-17

VERBATIM

The big risk today is NOT investing in China.

— Larry Ellison, Chairman and CEO, Oracle Corp.,
commenting in a press Q&A during his recent visit to Beijing

You can't just ask customers what they want and then try to give that to them. By the time you get it built, they'll want something new. It took us three years to build the NeXT computer. If we'd given customers what they said they wanted, we'd have built a computer they'd have been happy with a year after we spoke to them—not something they'd want now.

Steve Jobs, CEO, Apple Computers.

Everything exists because of the customer. All action taken should relate to how it will help the customer.

— Y P Radhakrishnan, Managing Director, SBI and the brain behind SBI's grandiose project.

Actually, it's a small world. We don't have to look for opportunities. They come to us.

— Chairman and Managing Director, Sterlite Industries,
on the series of acquisitions by the Sterlite group in the disinvestment process

This combination will be effective as quickly as possible to absorb the best of both sides.

Bobby Parikh, Chief Executive Officer, Arthur Andersen India, on merger between E&Y and Arthur Andersen.

We don't want India to be left behind in the trade game, but unless India shows that it wants to be taken seriously, the possibility that India will be left behind is all too real.

William Lash, American Commerce Department official

We want good businesses. A good business with decent management is better. In a bad business, the value that a good management can add is very low.

Samir Arora, CIO, Alliance Capital,
on the choice between companies with good management in bad business and companies
with bad management in good businesses.

STUDENT UPDATE

July 2002 Examinations

The next ICFAI Examinations for CFA Foundation Course, DBF and PGDFA Programs are scheduled to be conducted from July 06, 2002 to July 28, 2002. The admit cards of the eligible candidates who have been registered for the examinations have been mailed and also placed on the website. Candidates can download the Admit Card with the help of password. Candidates can create their own password.

Candidates who are eligible to take the examinations but not registered by June 15, 2002 can utilize the walk-in registration facility to appear for the examination. They are required to note the following:

1. Walk-in Candidates should submit a separate ERF for each subject.
2. Examination fee along with walk-in registration fee is to be paid by way of demand draft only. Payment by cheque or cash will not be accepted.
3. Candidates should write on the back of the demand draft their enrollment number, name and subjects which they want to appear.
4. Candidates should reach the Test Center one hour before the examination and meet the chief supervisor to complete the walk-in registration formalities.
5. Candidates are advised to satisfy themselves about their eligibility to appear for the examinations (Please refer the ICFAI Candidates Regulations, 2002 / ICFAI Foundation Course Regulations, 2002 for eligibility). If ineligible candidates appear for the examinations, their answer scripts will be treated as invalid and the examination fee paid by them will be forfeited.

New Test Centers

We are happy to inform that ICFAI examinations in July 2002 will be conducted in 45 cities. The addresses of Test Centers in 29 cities are given in Annexure IV of the ICFAI Candidates Regulations, 2002. The names of 16 additional cities where ICFAI examinations will be conducted are as follows.

City	Center Code	City	Center Code	City	Center Code
Agra	133	Jamshedpur	140	Siliguri	150
Allahabad	134	Kolkata	141	Surat	151
Amritsar	135	Madurai	143	Udaipur	152
Ghaziabad	137	Mangalore	144	Varanasi	153
Gwalior	138	Mysore	146		
Jabalpur	139	Ranchi	149		

The addresses and other details of the Test Centers in the above cities are available on the website www.icfai.org. Candidates who wish to appear for the examinations at any of the above-mentioned centers are requested to take note of the same.

Correspondence with the Institute (New E-mail ID)

We are happy to inform that the Institute is providing the Same Day E-mail service to the candidates enrolled in the various distance learning educational programs. In view of the above, we request all the students to correspond with ICFAI only through E-mail in order to get prompt response. ICFAI responds to the candidates' queries only through E-mail. Hence, all students are requested to correspond only through E-mail with the Student Services Department to get prompt response. For the convenience of the candidate the Student Services Department has changed the E-mail ID from studentservices@icfai.org to the following.

ssd@icfai.org

Candidates are advised to use the above E-mail ID for mailing any query to the Student Services Department.

Annual Service Charges

Candidates of the DBF/PGDFA Program who are enrolled on or after April 01, 2000 may note that they are required to pay Annual Service Charges every year. The period of one year is reckoned from the date of enrollment.

With effect from April 01, 2002, the candidates are required to remit the Annual Service Charges before 1st of the month in which the service charges become due for payment. A late fee of Rs. 100 per month is charged in case of delay in remitting the Annual Service Charges.

All candidates who have enrolled in the DBF/PGDFA program on or after April 01, 2000 and not yet remitted the Annual Service Charges for the year 2001-2002 and/or 2002-2003 are required to remit the Annual Service Charges with a late fee of Rs. 100 per month. Annual Service Charges can be remitted using Form 110 of the ICFAI Candidates Regulations, 2002.

The candidates, who do not remit the Annual Service Charges, will be denied all the student services without further notice.

Training Classes: July - September 2002

We wish to inform to the candidates that the next batch of the Training Classes for Group Alpha of the DBF/PGDFA Program and the CFA Foundation Course will be conducted during July - September 2002 at all the ICFAI Offices in various cities. The Training Classes are likely to start from July 15, 2002 at all the ICFAI Offices. The detailed schedule of the Training Classes will be made available at the respective ICFAI Offices. Candidates who are interested to attend the Training Classes are advised to contact the nearest ICFAI Office and register for the Training Classes by paying a fee of Rs.1250 per Subject. Candidates may note that the Training Classes for the Subjects of Group Alpha will be conducted at the ICFAI Offices subject to a minimum registration of 10 candidates for each Subject.

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ICFAI Books publishes professional books containing articles of enduring value on select themes in the areas of Finance, Management, E-Business and Information Technology.

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Case Study Series Banking & Financial Services 81-7881-041-7	Case Study Series Global Brands 81-7881-047-6	Case Study Series Services 81-7881-053-0	Banking Series Bank Credit - Emerging Trends 81-7881-051-4	Marketing Series E-Marketing - The Emerging Trends 81-7881-063-8
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The books are available at all leading bookshops and ICFAI Centers. Orders can also be mailed (quoting the above numbers) directly to ICFAI Press, 52, Nagarjuna Hills, Punjagutta, Hyderabad 500 082, India.

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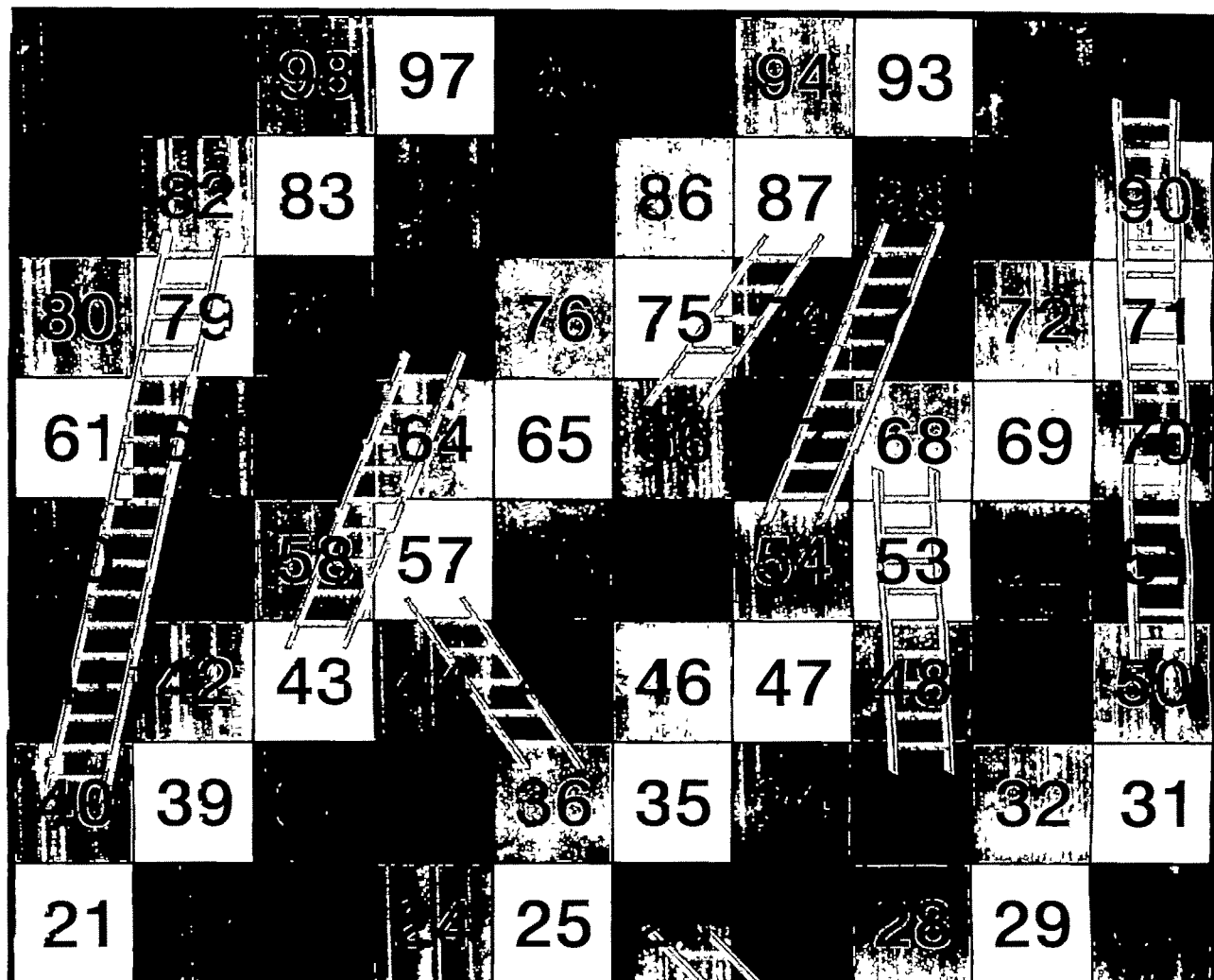
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